TAX PROPOSALS TO FOSTER SMALL BUSINESS EXPORTS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

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THURSDAY, APRIL 14, 1983

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAX, ACCESS TO EQUITY
CAPITAL AND BUSINESS OPPORTUNITIES,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2359-A, Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. NOWAK. The subcommittee will come to order. We have the day set aside, so we are going to proceed with the hearing. As many of you know, one of the great leaders of this Congress, Phil Burton, passed away very suddenly and the Congress is not going to be in session today because of that. Many Members have gone to the funeral.

We are going to proceed because I think the testimony that we reviewed, and the comments already submitted, will provide us with a record that we can share with all our committee members, and other Members of the House who are going to be looking at this subject very shortly, and especially those Members on the Ways and Means Committee.

I have a brief opening statement and then I think we will proceed right to the testimony.

The subcommittee is conducting an investigatory hearing today regarding tax proposals to foster small business exports. In particular, witnesses will discuss the impact on small business of the administration's recent proposal to replace the existing Domestic International Sales Corporation tax incentive.

DISC was enacted in 1971, with the objective of stimulating exports through a lowering of the effective tax rate on export income. To the extent DISC satisfies the "gross receipts" and "gross assets" tests of the statute, and as long as it increases export sales over a base period amount—the so-called increment provision—it is generally permitted to defer the tax of 42½ percent of the export income.

With respect to its impact on the American economy, there were 7,933 DISC's actively participating in 1980, with total export gross receipts of $132 billion. This amounts to an increase in DISC export receipts of approximately $32.4 billion over the year before.

Although DISC is an important incentive for increasing the relative level of American exports, many smaller firms find the provisions both cumbersome to implement and complex to maintain.

One witness at our hearings on this subject last September suggested that the cost of setting up a DISC can easily amount to as much as 50 percent of a company's export earnings in the first year.

I find the administration's "foreign export sales corporation" proposal as being presented to Congress at certainly a most opportune time. With the passage of the Export Trading Company legislation last year, there is a mood within the 98th Congress to develop a comprehensive export strategy or initiative for the entire Nation. I fully support such an effort.

Viable tax incentives should be considered as an important element of any comprehensive export initiative. This coordinated policy must also include viable loan incentives for smaller firms through the Export-Import Bank and other Federal agencies.

Last, it should encourage State and Federal agencies to provide general marketing and financing information to our small business community. Increased exporting could have a dramatic impact on the Nation's work force. This is significant in the light of the fact that small business creates approximately 80 percent of all the new net jobs in the United States. Further, a comprehensive export strategy will be utilizing an important avenue for broadening the country's economic base.

This would provide our cities with a hedge against general downturns in our economy, and with a means of increasing business opportunities for other domestic industries and suppliers.

Whatever is developed by the administration and Congress as a replacement for DISC, the new provisions should not be unduly complex for smaller firms. This includes a thorough examination of the current complexities of DISC and of those alternatives utilizing "substantial" foreign presence and arm's-length pricing rules.

We have with us Jim Olin of Virginia. Jim, do you have any statement at this time?

Mr. OLIN. No, thank you.

Mr. NOWAK. Thank you. We will, therefore, go right into the schedule of witnesses.

Our first will be Andre Fogarasi, from Arthur Andersen & Co., who is a principal in the office of the Federal tax service of the international firm. He was formerly a special assistant to the Under Secretary for Tax and Economic Affairs of the Department of Treasury.

He received his J.D. degree from the University of Connecticut, and an L.L.N. in taxation from New York University.

Would you come forward, please? We have your formal testimony and I will let you proceed in any manner you want. I just want to ask unanimous consent that the full text of your testimony will be submitted in the record.

TESTIMONY OF ANDRE P. FOGARASI, PRINCIPAL, AND INTERNATIONAL TAX LIAISON, OFFICE OF FEDERAL TAX SERVICES, ARTHUR ANDERSEN & CO.

Mr. FOGARASI. Thank you. Good morning, gentlemen.

I am not going to go over the full testimony. I would rather leave some time for questions and answers. I think there are a lot of questions in this area that you should look into.

I think basically that you ought to be aware that the DISC issue is a political GATT issue; it is not really one of these issues that are generated by legal wheels. In other words, there is no problem with DISC from a domestic standpoint legally. The reason the Treasury Department and USTR has agreed, I think at this point, to change it is because of political pressures put upon them by the European community as a whole.

So you have to sort of view this whole problem in the context of a Europe versus United States trade policy warfare.

The administration's proposal really goes a long way. I am not here to knock it and I think they ought to be commended for the fact that they have proposed something that will simplify the DISC rules for large companies.

I know that now we are dealing with the small businesses and that is your focus, so let's get down to what it does for small business.

The two proposals that they put forth are the interest charge and the joint venture proposal. The interest charge proposal basically is based on a footnote in the GATT law, which says that if you defer taxes by charging arm's length interest rate on it, then it will not be considered a violation of GATT as a subsidy.

Now, you have to come up with an interest rate at arm's length. The proposal by the Government is that it is the Treasury bill rate, that you would have to charge on the deferred tax amount. What the Government hopes that the small businessman will do is to pay the interest on this deferred amount, deduct on its income tax, and at the same time, invest this money that they are saving at a higher rate of return.

So in effect, what you become is an investor in the interest market. You are going to have to play the futures market on interest. You have got to predict how the interest rates are going to go, and we have had a lot of clients that we have talked to—we do not represent any of them in this hearing—whose reaction has been that you have to have somewhere around 15 percent rate of return presently in the market, based on the present Treasury Bill rate, to make it worthwhile. Not only is this unpredictable, it is highly complex.

From everybody we have talked to, we got the input that it is not a very practical, viable solution, and in the long run, if you operate a DISC based on these rules, the interest charge keeps escalating because it is based on the deferred tax amount.

If the business is successful, it will have larger and larger amounts of taxes that are deferred, which are being charged with the T-bill rate, and so that is not very good.

The other proposal is the joint venture proposal, which by the way, is presently in the DISC rules as they are enacted by Con-

gress. Not too many people take advantage of it for business reasons. The reason is that businessmen generally do not like to share marketing ideas, gross profit margins, and those sorts of ideas with other competitors. Therefore, if you have a pooling concept, it can only work if you have minimal ministerial duties that are required.

Now, let's go and quickly discuss the negatives, the main negative, which, Mr. Chairman, you already mentioned. That is, that the administration's proposal proposes to set up a foreign sales corporation and it will require activities to be conducted offshore.

They defined "outside the United States" under the customs laws of the United States. Therefore the territories such as the Virgin Islands and Guam would qualify as a place of incorporation and a place of activities for businesses that would have to go offshore of the United States.

The reason that they use this definition, I think, is because the GATT countries use a territorial concept, which basically means that beyond their boundaries, that is foreign soil, and you do not have to worry about anything which takes place outside of your soil. Whatever charges are out there, or whatever income is generated out there is not taxed by the home country.

The fact that you have to force a small businessman to incorporate outside the United States, or even in the Virgin Islands and Guam, is something that is probably abhorrent to him psychologically and with respect to his pocketbook. It will cost him money.

You could probably make that easier because there are precedents. I think if you look at the shipping area where the Liberians came to New York and San Francisco, set up their offices to incorporate U.S. shipping businesses in order to take advantage of the U.S. tax laws, you could probably ask Guam and the Virgin Islands to set up offices in the United States to facilitate the incorporation of small businesses. However, the administration's proposal requires that activities be performed outside the customs territory of the United States.

That means solicitation, negotiation and some of the other activities that are listed in the exhibit would have to take place outside the United States. Physically, that would be not only very difficult, but it would be very costly for small businesses. Therefore, I think that offshore activity should be changed with respect to small businesses.

There is a lack of incentive in the administration's proposal in that they do not distinguish between small business and large business. Presently, small business receives an extra incentive under DISC rules. The administration's proposal does not carry forward that distinction.

The joint venture proposal we already mentioned is not very viable. Suggestions: Let's turn to the positive side. I think there is a good argument to be made that small businesses, if they incorporate outside the United States, maybe in Guam and the Virgin Islands, should be allowed to fulfill their foreign activities in the foreign trade zones located in the United States and Puerto Rico.

Foreign trade zones are legislative creatives. They were set up in 1934 by Franklin Delano Roosevelt to stimulate foreign commerce and create jobs in the United States. You could require that small businesses perform whatever ministerial duties the administration

listed in its category III, such as holding board directors' meetings, having an office, maybe, or having an employee there.

You could require that activity to take place in the foreign trade zone. It will be a lot easier. We have approximately 80 foreign trade zones right now in the United States, located in various cities. You know, there is Buffalo; Miami is very active, you have New York; in the Midwest, Kansas City. I have here with me a brochure that National Association of Foreign Trade Zones puts out and explains some of these concepts and I will leave it with you.

I think it is fairly enlightening that you could do this all within the United States and not lose any jobs, because when you require foreign activities, you are going to lose some U.S. jobs.

I think, even though you are going to have these activities take place in the foreign trade zones, they should be minimal. In the event that you decide in your own judgment that activities have to take place outside the United States, I think you ought to encourage that those activities take place in Guam and the Virgin Islands. They are U.S. territories; you would really be substituting revenues. Instead of a direct transfer of revenues, you could have an indirect transfer of revenues by making small business or other companies go there.

There is one last point that I think you ought to consider and not dismiss. Really, the GATT countries believe in form over substance. They do everything in form, but then there is a question as to how much is enforced; how much they actually do.

In view of that, and in view of the fact that small business does not export so much to create an injury to the economy of GATT countries in the European community as a whole, you should consider exempting small business in general from any of these rules with respect to foreign activities.

When I say "injury," you know in basketball there is the expression "no harm/no foul," and what you have here is somewhat the same thing, because you have a small business company exporting into the European community. They do not reduce their prices in general, and therefore they do not become more competitive with the European manufacturer.

They take the DISC benefit and put it down to the bottom line. That is extra profit. That is what they need as an incentive to go over there. So if they are selling for the same price, my question is: How are they injuring the European community?

Under the Subsidies Code, the European community would have to prove injury to their economy. Nobody has done that yet. They have set up a panel recently to investigate the injury created by DISC to the European economies, but if history is anything like the last 10 years, they will not come up with a solution unless it is a political solution for the next 10 years as to whether there is injury.

With that, I will close and I recommend to the committee that they look into the free trade zone, which is both called the free trade zone and the foreign trade zone, depending on who uses that terminology. I think it is a very good solution to small business.

Thank you.

[Mr. Fogarasi's prepared statement with attachments follow:]

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PREPARED STATEMENT OF ANDRE P. FOGARASI, PRINCIPAL, AND INTERNATIONAL TAX LIAISON, OFFICE OF FEDERAL TAX SERVICES, ARTHUR ANDERSEN & CO.

My name is Andre P. Fogarasi. I am a Principal in the firm of Arthur Andersen & Co. and International Tax Liaison in its Office of Federal Tax Services. We welcome this opportunity to testify before the Committee today on the subject of DISC and export tax incentive.

The Arthur Andersen worldwide organization conducts an international accounting practice. We have many clients that have a particular interest in the subject of this hearing; however, we do not represent them in this testimony and the views expressed are those solely of the firm.

Our remarks, for the most part, will be limited to a discussion of the Administration's proposed alternative to the current domestic international sales corporation (DISC) provisions and will not discuss such matters as Export Trading Companies or whether to extend export incentives to service companies. A copy of the proposal, as well as the abbreviated statement of requirements related to this proposal, are attached to this statement as Exhibits I and II.

SUMMARY OF ADMINISTRATION PROPOSAL

Under the proposal, the domestic international sales corporation would be replaced by a foreign sales corporation (FSC), i.e., incorporated outside the U.S. customs territory, but including the Virgin Islands, Guam and the Northern Mariana Islands. Income from export sales made through the FSC would be exempt from U.S. tax. The FSC would be required to demonstrate that it engaged in economic activity outside the U.S. An arm's length pricing rule would be used to determine the income of the FSC or, if certain additional requirements were met, the income could be determined according to one of two allocation rules designed for administrative convenience.

The FSC would be required to maintain an office, books and records, and a bank account with paid-in capital outside the U.S. At least one director must be a non-U.S. resident and director and shareholder meetings would be required to be held outside the U.S. To qualify for the administrative income allocation rules, some economic processes and activities (e.g., solicitation, negotiation or acceptance of sales; processing orders; billing customers, etc.) would have to be performed outside the U.S.

The proposal also provides two potential modifications for small businesses. The first, an interest charge alternative, would allow exporters to continue to operate their present DISC's for up to $10 million in sales if the DISC pays an interest charge equal to the Treasury bill rate on the amount of taxes deferred each year by the DISC. The deemed dividend rules and incremental rules would be eliminated and the portion of DISC income available for tax deferral would be increased to 100 percent. The second alternative would allow the formation of an FSC on a joint basis. The joint participation could extend to both usage and ownership so that participants would receive distributions on a patronage basis.

In brief, while the Administration's proposal is probably an acceptable and desirable solution to the long pending DISC controvery as it relates to large exporters, we believe it has severe drawbacks with respect to small exporters for the following reasons:

1. The Administration's proposal requires small exporters to incorporate outside the U.S. customs territory and to conduct certain economic activities outside the U.S. (See Exhibit II).

2. The proposal provides that, if certain activities are performed outside the U.S., the FSC can elect the administrative allocation rules to determine the proper income to be allocable to the FSC. The administrative allocation rules do not distinguish between small and large exporters; they would both receive an exemption on the same percentage of profits. Because participation by small business in exporting activity has been viewed as particularly favorable, it may be appropriate to provide an additional benefit as an incentive to them.

3. The proposal requires that more stringent economic activities be performed outside the U.S. than those observed by other GATT members. The actual economic activities to be required should be refined and clarified by Congress so as to minimize the actual activities that have to be performed outside the U.S.

4. The Administration's small business options such as joint ownership of the FSC or an interest charge on the deferred tax do not appear to be viable on a long-term basis.

We suggest that Congress and the Administration consider the following modifications that could substantially aid small exporters:

1. In the event that economic activity has to take place outside the U.S. customs territory, those activities should be permitted to take place in foreign or free trade zones located in the U.S. and Puerto Rico.

2. If the Administration is unable to justify the free trade zone concept, it should reduce the required economic activities for small exporters to those mentioned in Category 3 of Exhibit II. Moreover, the Administration should encourage Guam, the Virgin Islands and the Northern Mariana Islands to reduce their income tax rates on FSC income so as to attract these companies and thereby help their revenue base.

3. The Administration should consider whether granting an exemption to export sales income for small exporters (e.g., gross sales under $10 million) without requiring any special export company (either foreign or domestic), would create sufficient injury to GATT members' economies so as to require U.S. reparations.

4. The Administration should explain how the accumulated deferred income will be dealt with. The Administration proposal states that it will not be subject to tax, but it does not clarify whether such funds can now be distributed tax free or whether they have to be retained in the old DISC in order to qualify for deferral.

Following is a more detailed discussion of these points including some preliminary observations regarding the impact of DISC on some problems faced by exporters.

BACKGROUND OF DISC

A recitation of the entire history of DISC and the criticism it has received at home and abroad from member countries of the General Agreement on Tariffs and Trade (GATT) would require much more time than is available here. Moreover, such a discussion would be somewhat moot inasmuch as it appears that there is a consensus now in the Administration that an alternative to the current tax rules must be found. In searching for that alternative, however, we believe that this Committee should keep in mind the problems faced by exporters that DISC was designed to counteract.

Prior to the enactment of DISC, a primary factor that adversely affected exporters was the vigorous application by the Internal Revenue Service of the intercompany transfer pricing rules of Internal Revenue Code Section 482. Due to their complexity, and the amount of detail that was needed to support the required arm's length transfer price, taxpayers exporting through related sales companies were subject to tremendous uncertainty regarding their tax liabilities. They could not be certain that their transfer prices and taxable income would be accepted. A readjustment of the transfer price by the IRS could—and frequently did—subject taxpayers to double taxation on their exporting profits. This possibility of double tax made exporting more risky and potentially less profitable than other sales activities.

The DISC provisions, by setting forth definitive rules for allocating profits between a U.S. manufacturer and its DISC, have eliminated the uncertainty that existed and the threat of double taxation and reduced profits.

The DISC provisions also responded to certain other tax and economic conditions that were disincentives to exporters. Among these were the potential for current taxation of the income of a foreign sales subsidiary under Subpart F of the Internal Revenue Code and the border tax adjustments made under the value added tax systems of various European countries. These adjustments imposed additional costs on exporters. Another factor was the unfavorable balance of trade attributable in part to the strength of the U.S. dollar.

Each of these factors continues to exist today as a reason to provide export incentives and relief from disincentives. They should, therefore, be taken into account when considering a DISC alternative. Certainty of pricing rules, elimination or at least minimization of the risk of double taxation, and removal of barriers that place exporters at a disadvantage by increasing their costs, are extremely important if the alternative is to prove viable.

THE DISC ALTERNATIVE

The proposal approved by the Cabinet Council on Commerce and Trade was formulated with four key objectives in mind:

(1) Consistently with the international obligations under GATT; (2) avoidance of any tax increase for exporters; (3) maintenance of revenue neutrality; and (4) preservation of the ability of small businesses to use the tax alternative.

Since these objectives are matters of policy, we have no comment on them. We will, however, comment with respect to whether the proposal appears to meet these objectives, particularly objectives 1 and 4.

IMPROVEMENTS OVER CURRENT DISC PROVISIONS

Despite its benefits, the current DISC provisions contain several drawbacks. One of these is the complexity of the requirements that must be met in order to maintain the status as a DISC. There are detailed rules regarding the character of income in the DISC and the type of assets the DISC might have or in which it might invest. For example, the DISC must hold certain qualified export assets, among which are obligations issued or guaranteed by the Export-Import Bank. There are also many other formal rules under the regulations that, if not met, could cause termination of DISC status and acceleration of the deferred tax liability for its shareholders.

The proposal appears to eliminate the need for many of these rules and, in general, makes important improvements. You should be aware that, to the extent the proposal eliminates the requirement to hold "qualified export assets," it could impact the availability of export financing in the future. Thus, other low cost loans would have to be made available.

An important aspect of this simplification is the psychological effect it could have on the willingness of small business to participate in the benefits of the proposal. The barrier presented by the DISC rules—that qualification and continued compliance would be possible only with extensive involvement by professional advisers—should be materially reduced after the initial setting-up stage. We view this as a very positive development.

SATISFYING THE GATT

It is, of course, impossible for us to determine whether the terms of the proposal satisfy the U.S. obligations under the GATT (i.e., are GATT legal). Trade representatives, government officials and special panels, not to mention learned international tax and trade professionals, have debated the issue of what is or is not required by the GATT for more than a decade. Whether all or substantially all of the enumerated economic activities or processes must occur outside the U.S. in order to support an allocation of income to the FSC should be carefully considered. The interests of U.S. exporters should not be sacrificed for the sake of a standard that is not known to be required or followed by other GATT members.

It well be that the status given under U.S. tax principles to substance-over-form far exceeds the standard applied by the other GATT members. If so, it may not be necessary to require foreign presence in more than a formal manner. For example, we understand if a Dutch manufacturing company establishes an export sales company in the Netherland Antilles, it can allocate as income of the sales company the same marginal profit that would be realized on resale by a third party. The export sales company can establish its bona fide status, in practice, by having one employee and the income can be allocated, for the most part, without regard to responsibilities or activities of that employee. This appears to be a more liberal rule than seems to be required by the Administration proposal that a certain percentage of the various costs related to the export activities be incurred by the FSC outside the U.S.

In any event, because criticism of the DISC by other GATT members has persisted for so long, it is reasonable to expect that some challenges to the DISC alternative will continue to be made regardless of the extent of activities required under U.S. rules to evidence foreign presence.

AVAILABILITY TO SMALL BUSINESS

The primary concern we have with this proposal, from both a small business and large company standpoint, would be the level of activity necessary to satisfy the foreign presence requirements. Under FSC, the potential for incurring additional costs due to offshore activities is likely to be even more intimidating to the small exporter than are the current DISC rules involving a "paper company." The small exporter might be totally unable to assume this additional cost and complexity. A major segment of U.S. business would, thereby, be denied this export tax incentive.

Because the estimated benefits of the proposal include those going to small businesses, failure of the proposal to satisfy the objective that it be available to, and used by, small business creates an additional problem. It would also, as a consequence, fail in its objective to be revenue neutral. Additional tax revenue would be generated at the expense of small businesses, who would perform their export functions through U.S. corporations that would not receive any export incentives.

CLARIFICATION OF REQUIREMENTS NEEDED

The primary cause of uncertainty as to whether the DISC alternative will be available to and used by small business is the lack of clearly defined requirements. While the Administration proposal sets forth many requirements, some of which are easily understood, it is by no means clear whether it is, in fact, intended that substantial economic activity must occur outside the U.S. For example, does the requirement to maintain the books and records in the foreign office necessitate that an employee located overseas post entries to a general ledger or is it sufficient that a copy of the year-end financial statements be kept in that foreign location?

The importance of clarifying the requirements cannot be overemphasized. It should be done by Congress with particularity so that the Internal Revenue Service, will not administer these requirements so strictly as to defeat the intent of the statute.

REQUIRED LOCATION OF ACTIVITIES—FREE TRADE ZONES

If it is determined that, indeed, actual economic processes must be performed "outside the U.S.," the meaning of that term should be clearly defined. Presently, the proposal would call for the performance of activities outside the U.S. customs territory (such as in the Virgin Islands, Guam and the Northern Mariana Islands.) We understand that this is the relevant criterion in a GATT sense.

We would suggest that this criterion might also be met by allowing these activities to be performed in the various free trade zones that exist in the United States and Puerto Rico. This definition of "outside the U.S." is attractive for several reasons. First, because free trade zones are not within the customs territory of the U.S., this would seem to satisfy the GATT obligations. Second, small businesses would be much more able and willing to operate in a free trade zone within their state, a nearby state or in Puerto Rico than in a foreign country. Finally, any additional employees that might be necessary for whatever activities may actually be required to satisfy the GATT with regard to income allocation would remain in the U.S.

ENCOURAGING USE OF GUAM AND THE VIRGIN ISLANDS

If the suggestion regarding use of free trade zones is not workable, the availability of the DISC alternative to small business will probably be reduced. Despite the ability to locate activities in Guam and the Virgin Islands, and the benefit from common language, tax philosophy etc., many smaller businesses may have a psychological aversion to locating anywhere outside the continental U.S., unless the level of required activity is quite low.

Activities such as those described in Category 3 of the proposal, (i.e., holding director and shareholder meetings outside the U.S.; maintaining bank accounts outside the U.S. and disbursing dividends and certain expenses from it), would not cause an undue burden. Small exporters should be able to meet these requirements without the need to relocate employees. Limiting the level of activities outside the U.S. to establish foreign presence to those described in Category 3 also has support in the practice of several European countries. Thus, it may be satisfactory to the GATT members.

In addition, it would be beneficial to encourage utilization of Guam and the Virgin Islands by those who have the ability to comply with the requirements for the FSC. However, the higher tax rate that applies in those territories relative to the Netherlands Antilles, for example, would probably operate as a barrier to such utilization. Consequently, efforts to encourage those territories to reduce their tax rate applicable to the export sales income of FSC's would be desirable.

SMALL BUSINESS EXEMPTION AS AN ALTERNATIVE

In order to satisfy the objective to preserve the ability of small business to use a tax alternative—in the event that substantial economic activities outside the U.S. were determined to be mandatory in order to satisfy obligations under GATT—it may be necessary to provide a special mechanism for small business. One solution would be the provision of an exemption from U.S. income tax for small exporters (e.g., gross sales under $10 million), on their export sales. If properly defined, this exemption would be of significance to small business but would not be large in relation to the total FSC proposal. For example, in the 1980 DISC year, DISC's with gross receipts under $10 million (nearly 85 percent of all DISC returns), accounted for less than 10 percent of total DISC gross receipts, according to the Treasury's 1980 Annual Report on DISC's. It would seem that an exemption could be provided, without all of the formal FSC requirements, to accommodate these small exporters

yet the benefits be relatively de minimis so as not to injure or offend other GATT members.

SMALL BUSINESS OPTIONS OFFERED BY THE ADMINISTRATION

The Administration suggested two options to accommodate the proposal to the need of small business. The first, joint participation by exporters in order to share the costs of the offshore activities, does not appear to be a practical solution. From our experience, we observe that small and large businesses alike are very protective of their independent status and would be extremely reluctant to share an FSC where information regarding marketing strategy, product pricing, etc., might become accessible to others (even if only under remote circumstances).

The other suggestion, that exporters could operate DISC's under the current rules for sales up to $10 million, provided an interest charge is paid on the deferred tax, is more difficult to assess. The prospect for continuing to operate a DISC under the current, complex rules is not very attractive. Furthermore, the economic burden of the interest charge would, we believe, exceed the current benefits of DISC after a period of time, depending upon the interest rate used and the cost of funds to the exporter. Finally, by increasing the amount of deferral but retaining the "qualified assets" requirement, this alternative compounds the problem many exporters are struggling with now trying to maintain a qualified balance sheet. Over time, therefore, this proposal would not be revenue neutral.

TREATMENT OF ACCUMULATED DISC BENEFITS

Whichever alternative to DISC is chosen, it is of great importance that Congress consider and decide upon the treatment to be given to the tax liability presently deferred under the DISC rules. The Administration's proposal is not entirely clear on this point but does suggest that the accumulated deferred income will not be subject to tax. This would be extremely beneficial to small business exporters and should be encouraged. Recapture of the deferral amount, whether immediately, in stages, or upon distribution from the DISC, would seem to penalize exporters rather than to benefit them, or at least to be revenue neutral. This would appear to be inconsistent with the objective to provide incentives for and support exports.

CONCLUSION

We view the proposed tax alternative to DISC as an improvement and believe that it will be beneficial to small business in mitigating the disadvantages faced by exporters. This is so, provided it is clear that actual, significant operations overseas will not be required. Such a requirement would be too costly to most businesses and too psychologically intimidating to result in significant use. We view the use of free trade zones in the U.S. and Puerto Rico as a particularly attractive means to satisfy the GATT concerns and the needs of small business. We would be pleased to work with the Committee in any way we can to accomplish those objectives.

Administration Proposal for a DISC Replacement

INTRODUCTION

On March 2, 1983, the Cabinet Council on Commerce and Trade approved a proposal for a tax alternative to the Domestic International Sales Corporation (DISC). This proposal meets the U.S. commitment made on October 1, 1982, before the Council of the General Agreement on Tariffs and Trade (GATT) to send a proposal for replacing the DISC to the 98th Congress. This commitment was made to resolve a long-standing GATT controversy over the consistency of DISC with U.S. obligations under Article XVI:4 of the General Agreement. This provision of the Agreement encompasses an obligation not to use export subsidies in certain circumstances.

The Administration's proposal was formulated with four key objectives in mind: (1) consistency with our international obligations under the GATT; (2) avoid any tax increase for exporters; (3) maintenance of revenue neutrality; and (4) preservation of the ability of small businesses to use the tax alternative. In addition, the proposal envisions a substantially simpler procedure for the taxation of exporters than is currently the case under DISC.

The proposal complies with the GATT rules regarding taxation of export income. Under these rules, a territorial tax system—which exempts from taxation income earned overseas—is permissible. Accordingly, the GATT does not require that a

country tax directly the income from economic activities outside its borders. This is consistent with other GATT provisions which do not prohibit the adoption of measures to avoid the double taxation of foreign income. The GATT does, however, require that territorial systems use arm's-length pricing rules to allocate income between related domestic and foreign economic entities. Finally, the GATT permits the deferral of direct taxes on export income if an appropriate rate of interest is charged on the deferred sums.

SUMMARY OF PROPOSAL

Under the GATT, the United States would *not* convey an illegal export subsidy if it exempts from tax income which is attributable to economic activity occurring outside the United States and requires an arm's-length pricing in transactions between related parties. To conform with this GATT standard, the proposal replaces the DISC with a foreign corporation through which export sales would be made. The income from such export sales would be allocated between the foreign sales corporation and a related U.S. company using the arm's length procedures prescribed under Section 482 of the Internal Revenue Code (hereafter referred to as the Code), or using one of two allocation rules designed for administrative convenience to approximate arm's-length pricing. The administrative allocation allowed with respect to export sales would be equal to the greater of: (a) 17 percent of the combined taxable income earned by the foreign corporation and its related U.S. manufacturer; or (b) 1.35 percent of the foreign corporation's gross sales, up to 34 percent of the combined taxable income. Up to the limits described below, the income allocated to the foreign corporation would be distributed to the parent on a tax free basis. To qualify for this tax treatment, the foreign corporation would be required to undertake certain economic activities outside the United States. Provisions are also included in the proposal to accommodate the special characteristics of small business.

PRINCIPLE ELEMENTS OF PROPOSAL

I. U.S. taxation of income earned by the foreign export sales corporation

A foreign export sales corporation will be entitled to an exemption from U.S. tax on a certain portion of its income from export sales (hereafter referred to as Foreign Trading Company Income or FTI) if it conducts economic activities outside the United States. The foreign export sales corporation must be incorporated outside U.S. territory. This requirement reflects the GATT rule that countries need not tax export income from economic processes occurring outside their territorial limits.

II. Foreign trading company income

FTI is defined as income (including both profits and commissions) derived in connection with foreign trading gross receipts. Foreign trading gross receipts are gross receipts from:

(a) The sale, exchange, or other disposition of export property;

(b) The lease or rental of export property which is used by the lessee outside the United States;

(c) The performance of services which are related and subsidiary to the sale, exchange, lease, rental, or other disposition of export property by the foreign corporation;

(d) The performance of engineering or architectural services for construction projects located outside the United States; and

(e) The performance of managerial services in furtherance of the production of foreign export trading gross receipts.

"Export property" generally means property manufactured, produced, grown, or extracted in the United States for direct use, consumption, or disposition outside the United States.

III. Arm's-length pricing rules

The price at which export property is transferred from the U.S. manufacturer to the foreign sales corporation will be determined using arm's-length transfer pricing principles. As a matter of administrative convenience, this arm's-length requirement will be met by an allocation equal to the greater of:

(a) 17 percent of the combined taxable income earned by the U.S. manufacturer and foreign sales corporation; or

(b) 1.35 percent of the foreign corporation's gross sales, but not to exceed 34 percent of combined taxable income. To use either of these administrative allocation rules, the foreign corporation must perform, or have performed on its behalf, the

activities described below. As an alternative to the administrative allocation rule, taxpayers may determine the allocation of income by transferring export property to the foreign corporation at a transfer price determined under Section 482 of the Code.

IV. Required foreign economic activities

To be eligible for tax exempt treatment under this proposal the foreign corporation must:

(1) Maintain an office outside the United States;

(2) Maintain books and records in that foreign office; [1]

(3) Have at least one resident director in the foreign office; and

(4) Hold an agency agreement or distribution license with respect to the product.

In addition, some or all of the following functions must be performed in part or in total outside the United States by the foreign corporation, or for it on a contract basis, in connection with foreign trading gross receipts:

(5) Soliciting orders from and negotiating contracts with customers;

(6) Processing customer orders; and/or

(7) Billing customers and receiving payments.

If, however, U.S. exporters as part of their normal business practice perform other significant activities outside the United States, consideration will be given to substituting those for some or all of the functions listed in items 5 through 7.[2]

As long as these foreign presence requirements are met, the foreign corporation will not be subject to U.S. tax on a portion of its FTI. These foreign presence requirements are necessary to conform to the GATT rule which allows for the exemption from taxation of income related to the economic processes occurring outside the exporting country. It should be noted, however, that these foreign presence requirements do not prevent a foreign corporation from maintaining an office in the United States, or from concluding contracts to have activities performed on its behalf in the United States.

V. Definition of U.S. territory

For the purposes of this proposal, the U.S. territories of Guam, the Virgin Islands, and the Northern Mariana Islands will be considered outside the territory of the United States. This definition conforms to the definition of territory as customs territory used in the GATT. Additionally, the foreign sales corporation can only be located in a territory as customs territory used in the GATT. Additionally, the foreign sales corporation can only be located in a territory or country which has an exchange of information agreement with the United States.

VI. Taxation of U.S. shareholders of foreign corporation

The tax exempt portion of FTI will not be included in the income of a U.S. shareholder under subpart F. In addition, U.S. shareholders will be allowed a 100 percent dividends received deduction with respect to actual dividends from earnings attributable to tax exempt FTI. The dividends received deduction will be in lieu of a foreign tax credit. Other earnings will remain subject to the existing U.S. tax regime, including the subpart F and foreign tax credit rules.

VII. Revenue neutral cap on the tax exempt benefit

The CCCT specified that the proposed alternative should cost no more than the DISC in terms of lost tax revenue. For taxpayers using an administrative allocation rule, the amount of tax exempt FTI will be limited to the greater of 17 percent of the combined taxable income of the foreign corporation and its related supplier; or 1.35 percent of the foreign corporation's gross sales, but not to exceed 34 percent of combined taxable income. If the foreign corporation purchases goods from an unrelated party or determines its transfer prices under the Section 482 regulations, the limit on the tax exempt benefit will be equal to 34 percent of the foreign corporation's FTI.

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[1] For purposes of U.S. tax administration and enforcement, it will be necessary for the books and records to be available for examination in the United States.

[2] These other significant activities might include: (a) Disbursement of export related advertising expenses; (b) Maintenance of separate bank account; (c) Maintenance of paid in capital; (d) Holding directors' meetings; (e) Holding shareholders' meetings; (f) Disbursement of dividends; (g) Disbursement of legal fees; (h) Disbursement of accounting fees; (i) Disbursement of officers' salaries; (j) Disbursement of directors' salaries; (k) Communicating with the general public; and (l) Transfer of title.

VIII. Simplification

Under the proposal, the tax benefit conferred on FTI is an exemption from U.S. tax on income attributable to foreign economic processes. The proposal eliminates conditions on the tax benefit such as the requirement under DISC that tax deferred income be invested in certain assets. The tax exempt funds can be made immediately available to U.S. shareholders of the foreign corporation tax free, without the necessity of complicated producer's loan type limitations.

The elimination of the asset requirement also avoids the problems presently associated with accumulated DISC income. Complicated "recapture" provisions for accumulated FTI will be unnecessary. The simplification of the measure will help offset the burden of conducting activity outside of the United States, particularly for small businesses.

IX. Small business options

Small businesses will be given the option of choosing either to pay an interest charge on deferred taxes or to participate in jointly owned foreign sales corporations.

(a) *Interest charge alternative.*—Under this alternative, exporters would be allowed to continue to operate their DISC's for sales of up to $10 million. An annual deductible interest charge would be imposed on the value of the tax deferral at the Treasury bill rate. The current pricing rules would remain in effect, but the deemed distribution and incremental provisions would be eliminated. Thus, up to 100 percent of the DISC income covered by this alternative could be deferred. This would be necessary to make the approach attractive in light of the additional cost associated with the interest charge.

(b) *Joint participation.*—This option would allow for the formation of foreign sales corporations on a joint basis. Participation would not be limited by type or size of firm. Non-profit entities such as state development corporations and port authorities could be used as the vehicles for foreign incorporation. The joint participation could extend to both usage and ownership so that participants would receive distributions on a partronage basis.

X. Treatment of accumulated DISC deferral

The proposal envisions the repeal of the current DISC provisions of the Code. The accumulated deferral income will not be subject to taxation under this proposal.

REQUIRED ACTIVITIES OF THE FOREIGN SALES CORPORATION

To be eligible for tax exempt treatment under this proposal, the foreign sales corporation must: (1) maintain an office outside the United States; (2) maintain books and records in that foreign office;[1] (3) have at least one resident director outside the United States; and (4) hold an exclusive or non-exclusive agency agreement, franchise agreement, or distribution license with respect to the product.

In addition, to be eligible for the administrative income allocation rules the following functions must be performed by the foreign sales corporation, or for it on a contract basis, in connection with foreign trading gross receipts: (5) solicit orders from and negotiate contracts with customers; (6) process customer orders; and (7) bill customers and receiving payments.

Furthermore, to be eligible for the administrative income allocation rules the foreign corporation must engage in foreign economic processes by satisfying the following three categories of requirements.

Category 1. The foreign sales corporation must participate outside the United States in the solicitation, negotiation, or acceptance of sales. Solicitation including advertising, direct mail, or other communications to related or unrelated customers or potential customers. Negotiation includes any communication relating to terms of sale. Acceptance means formal legal acceptance.

Category 2: The foreign sales corporation must perform outside the United States activities that give rise to 50 percent of the costs associated with items 1-5 below, or do substantially all (85 percent) of two of the following: (1) Process customer orders; (2) bill customers or receive payment; (3) engage in advertising and promotion activities; (4) contract for payment of commissions or fees to related or unrelated agents;

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[1] For purposes of U.S. tax administration and enforcement, it will be necessary for the books and records to be available for examination in the United States.

and (5) assume credit risk, risk of loss from casualty, damage, etc., and foreign exchange risk.[2]

Category 3: The foreign sales corporation must perform substantially all (85 percent) of the following activities outside the United States: (1) Hold board of directors and shareholders meetings; (2) maintain a separate bank account and paid-in capital; and (3) disburse dividends, legal fees, board of directors and officers salaries, and accounting fees.

Where the U.S. exporter or the foreign sales corporation sells to a related foreign buyer, the activities in categories 1 and 2 above relate to transactions between the seller and the related foreign buyer.

Mr. NOWAK. Thank you very much for your testimony.

Let me ask you a couple of questions. You talk about the foreign trade zones. Do you have an idea as to how many foreign trade zones there are existing out there now?

Mr. FOGARASI. Eighty, approximately, Mr. Chairman. One of the things that I think you ought to be aware of—I failed to mention it—that foreign trade zones are not unique to the United States. As a matter of fact, it started back in Carthage days in history, and the Europeans have quite a few of them. There are approximately 300 around the world.

As a matter of fact, in Belgium right now, there is a decree, a royal decree, which would allow foreign companies to come into a free trade zone in Belgium for high-tech purposes, manufacturing high-tech products, without being subject to tax in Belgium.

A second one is now pending which would allow reinvoicing centers to be located in Belgium. By reinvoicing, it is really insurance, accounting, factoring incomes and that sort of thing, and there would be no tax consequence to the people who come there. The reason they are doing it is to attract jobs.

Mr. NOWAK. You spoke of a fiction, and that this is a political matter that is trying to be solved through what really is pure fiction, the setting up of a corporation to avoid being GATT-legal.

Is there anything at all you can say as a substantive reason which would accrue by setting up a foreign sales corporation?

Mr. FOGARASI. If you mean, will it satisfy the GATT members, I think, in my experience, and I have gone to negotiate in Geneva several times, if Congress comes up with a rule, it will be challenged anyway. But as long as there are conflicts between the trade policies of the European countries and the United States in agriculture and services and insurance and banking, they will always bring up DISC or its counterpart as a reason why the Europeans cannot agree to mitigate their own subsidies policies.

Mr. NOWAK. To your knowledge, has Treasury or anybody else who has been negotiating any kind of agreement that this format Treasury has proposed would be acceptable to GATT?

Mr. FOGARASI. To my knowledge, they took over the administration's press release, I think it is attached in my testimony, but they did not discuss the specifics with the GATT members. To my

[2] The assumption of risk implies an additional burden or gain for the foreign corporation than that implied by the normal calculation of combined taxable income. If a foreign corporation chooses to incur these additional risks, an additional adjustment will be made to the income allocated to the foreign corporation to derive that portion of the income that will be exempt from tax. The adjustment will be the subtraction from the foreign corporation's income allocation of 17 percent of all the losses incurred by the related parties resulting from these risks, and the addition to the foreign corporation's income allocation 17 percent of all the gains for the related parties from incurring foreign exchange risk.

knowledge, there was no tax representative from U.S. Treasury there at the last meeting, only U.S. Trade Representative's Office was there.

So I do not think——

Mr. NOWAK. What I am trying to say, we may go through all of this fiction, spend enormous amounts of money, especially from a percentage of the smaller business operating company, to set up all of this and then 2 or 3 years down the road, end up in exactly the same position we are in today, with this being termed GATT-illegal.

Mr. FOGARASI. I think, Mr. Chairman, there is a pretty good likelihood that that is what is going to happen. You know, whatever you come up with will be criticized and will be litigated through the whole panel process of GATT for the next 5 years.

On the other hand, as somebody said, optics are the key, so this is an optical solution. As long as that is the way you view it, and you do not require real substance, but rather you go with form, it may work.

Mr. NOWAK. Have you thought about any other appropriate or additional benefits that could be put into this legislation, if it is forced through?

Mr. FOGARASI. No, I think one of the things that you ought to be aware of, and I am not an expert in financing, is that once you eliminate the DISC rules, you dry up a certain amount of funds that are presently sitting in Eximbank and PEFCO obligations, which get a very low rate of return, and have been criticized by many business people as really not a fair return.

What it does, it does create a pool of funds for exporters and once you eliminate these rules, you will have to provide low interest rate type subsidies for financing anyway.

Mr. NOWAK. Let me just try to clarify this, sir. What, in your opinion, happens if this were ended, this whole DISC program, and nothing further was done, what would happen with the corporation's deferred income that has accumulated?

Mr. FOGARASI. Well, the administration's proposal states that they would not tax the deferred income; however, they do not tell you what they mean. That is a point that is very sore with the business community.

You could have two options: One is that you could say you forgive the deferred tax amount and we have a new ball game. Forget about what happened for the last 10 years and you can take your money home and liquidate. The other option is that you roll over into this new entity tax-free the deferred tax amount and then later on, you withdraw it from this new entity on a tax basis, to be consistent with the present rules.

I think those are two options and the administration has not come out and stated which is their position, but if I were guessing, I would tell you that it is the latter; it is not the former.

Mr. NOWAK. Thank you.

Mr. Olin.

Mr. OLIN. I just have a couple of questions. I take it from your comments that really what is being proposed is a sort of a synthetic solution to the objection that the European community has. If

we end up establishing a lot of activities on the Virgin Islands or Guam, we will not really alter the thing that they are objecting to.

Mr. FOGARASI. Well, yes, but it is not even a question—I think there is not that much synthetic. There is a lot of activity that the actual proposal would require you to do overseas. I think that is one of the key things that you have to realize. The United States, in its usual wisdom, at least the Treasury Department, is putting down the U.S. rules and applying them where they say form is not valid; you have got to have substance over form.

Substance can only come by having actual economic activities take place outside. We are taking this rule very seriously. The question is, nobody on the other side of the Atlantic has defined that economic process and nobody there really believes that you have to have a lot of substance to it.

As a matter of fact, one of the examples that is in my testimony is a Dutch company; that if it wants to set up in The Netherlands Antilles, if it has an employee there, automatically they allocate a marginal profit to that company, which would be the equivalent of a third-party's margin.

That is it. The IRS would not accept that, I guarantee it.

Mr. OLIN. Could you, for my benefit, since I am not really an expert at this, describe again what activity would have to be literally in a foreign country and what activity could be in these intermediate areas like Guam?

Mr. FOGARASI. Well, I think, first of all, the Administration would want you to take into account all activities everywhere. Guam and the Virgin Islands are thrown in there basically as a place where you could do it instead of going to The Netherlands Antilles, for instance. That is another key point that I will come back to.

For instance, in exhibit 2 attached to my prepared statement, you have it right there, it is easier than my reading the whole thing off to you, category 1, and category 2 are really the main activities that have to take place outside the United States, and by the way, this is the only explanation that the business community has seen. There has been a lot of oral interpretation of this, and if you ever enact anything like this, I think you better take great care to define the terms, because the IRS will define it for you in a very strict sense.

If you look at category 1, it has "foreign sales corporation must participate outside the United States in the solicitation, negotiation, or acceptance of sales." That means outside, it has to be outside the customs territory. That means you have to have somebody either out there in your employment, or you have got to have an agent out there. Somehow, you have got to have presence.

Category 2 goes through some of the activities, and then there is a percentage test. You could do 50 percent of items 1 through 5, or 85 percent of two of those.

The administration has said, at least, you know, that it is not very hard to meet items 4 and 5. They fail to see the point that just locating overseas may be a problem for small business.

Mr. OLIN. I would say that that would be a substantial problem.

Mr. FOGARASI. It is a psychological problem, also, as opposed to just out-of-pocket costs.

Mr. OLIN. Could I ask you your opinion? There must be practices of GATT that the United States has objections to. Ambassador Brock must have an idea, in proposing these controversial changes that he is going to use them as a bargaining point to get some benefits on the other side.

Do you know of such a type of swap?

Mr. FOGARASI. No, I really do not, but I would presume that if I were bargaining, I would take the position that I would want to bargain off one element for the other. I know Ambassador Brock has a lot of problems right now.

Mr. OLIN. What do you think the likelihood would be of continuing to function with DISC just as it is, leave it alone?

Mr. FOGARASI. Well, as you know, GATT members set up a panel committee to investigate the injury that DISC has created in the European community. Now, when they go back to the violations of GATT rules, you have to prove that there is dual pricing, meaning that there is a lower price being set for exported items, and you have to prove injury.

Those two steps are very difficult to prove, as you know. Economists argue day and night and they never could agree whether you have injury or not. I do not think they ever will.

But with respect to the Subsidies Code, which is the 1979 agreement, there you just have to prove injury. You do not have to prove dual pricing anymore. Again, you have to show an economic injury, and I do not know how long that takes.

So if you leave DISC in place, you are going to have to go through this litigation procedure, which is the panel process. The last time the DISC was investigated, there were no Americans on that panel; they were all Europeans. So if that is the way the selection comes up this time, you can figure out what the answer is.

Mr. OLIN. Prior to coming to Congress, I was a manufacturer of heavy electrical equipment, engaged in international trade. I was in charge of this business during the time when DISC was first started. I was never aware in this big company that we did any more international business than we would have done otherwise, or that we priced our product differently than we would have otherwise.

It would have been almost impossible for anybody to demonstrate that the fact of having DISC had much to do with our economic activity abroad. I expect that the same thing would tend to be true of small companies and that proving this point would be extremely difficult, as you say.

Let me ask you another question, then. If you made the assumption that we left DISC alone, and just continued to have this complaint, what changes, with regard to the treatment of the small businesses, would you recommend in the present DISC structure?

Mr. FOGARASI. Well, I think under the present DISC structure, you ought to simplify it, because I think you have very complex rules. Under the present rules, the incremental rules do not apply to small business, but there is a $100,000 limitation. You probably should increase it.

You have a tremendous amount of problems for small businesses of meeting all the technical requirements and regulations. If you fail to meet that requirement, you disqualify it. It is one of these

all-or-nothing tests. A man can wake up January 2, talk to his accountant, and realize that he blew the whole benefit that he thought he got the previous year.

That is really, I think, the crux of the matter. It has to be simplified and it has to interpreted liberally. That was the original idea when the DISC export report came out by the Commerce Department back in 1971, but unfortunately, you know, things go from the right hand to the left, and then it was IRS and Treasury that wrote the regulations.

You have to write sort of tough regulations in order to make sure that everything works, but there is no facts-or-circumstances test; it is a clear-cut test. It is a percentage test, it is a day test, you have to do certain things within 60 days. If you do it on the 61st day, you lose all benefits.

Mr. OLIN. Do you have a feeling for how much of small business is failing to take advantage of export opportunities because of the complication of DISC?

Mr. FOGARASI. No, I would not even venture to take a guess at that. I think you could take a look at the Treasury Department's report, and I think 85 percent is under $10 million gross sales. That only accounts for 10–12 percent of the deferred tax.

You have a lot of small businesses already participating, those that are really sophisticated enough to hire legal and accounting professional help in order to set this up. Smaller ones do not and have not gotten out there yet.

Mr. OLIN. Thank you very much, Mr. Chairman.

Mr. NOWAK. Thank you. We also have with us from North Carolina—if you would stay just for a few minutes, Mr. Fogarasi—Robin Britt from North Carolina. He may have some questions. We have one more member after that, sir.

Mr. FOGARASI. Sure.

Mr. BRITT. Thank you, Mr. Chairman.

You just gave some numbers and I was not quite sure. Eighty-five percent——

Mr. FOGARASI. Eighty-five—I do not know if you have the DISC report. This is the Treasury Department's annual report. It is the 1980 annual report, and there is a table in the back, table 4.3; it shows 85 percent of DISC returns had under $10 million gross receipts, and I think that accounts for about 10–12 percent of the deferred tax amount.

Mr. NOWAK. What page are you referring to?

Mr. FOGARASI. It is on page 23.

Mr. BRITT. There are 8,000 DISC's, roughly, active DISC's. What percentage of that would you say might be small business, do you have any idea?

Mr. FOGARASI. No, I really would not know offhand.

Mr. BRITT. How important do you think DISC's are to U.S. imports? Congressman Olin has mentioned that he really never saw any decisions made, pro or con, based on the availability of DISC's. What would happen to our exports if there were no DISC's, in your estimation?

Mr. FOGARASI. That is, you know, that is a little difficult to prove as to what happens. You know there has been an argument in

Treasury that basically DISC supports the already preexisting exports.

I think it is very difficult to prove one way or the other. It is somewhat like a feedback approach.

Mr. BRITT. In your estimation, do you think it is a major incentive, moderate incentive, or is it not that important?

Mr. FOGARASI. No; I think it is somewhere between moderate and major for small business.

Mr. BRITT. So you think that we need to maintain some type of tax incentives to export for deferral of income tax or something?

Mr. FOGARASI. Yes, based on all the competition that you have around the world, and some of the other discriminatory trade practices, I think you do.

Mr. BRITT. We have mentioned the complexity of DISC's to small business, and I think this is true in a lot of areas. I think it is true in export, per se, just the redtape involved in exporting. If the small businessman could sell to foreign markets as easily as domestic, we would see a lot more exports.

If you were drafting a statute to provide tax incentives to encourage small business exports, in a nutshell, just off the top of your head, what are some ideas you might have in that regard?

Mr. FOGARASI. Well, I think one of the things that I would do away with is the qualified asset test, which is basically what DISC companies have to reinvest their earnings in. One of the reasons I think that there was that limitation back in 1970 was to make sure that there was a pool of funds available for exporting.

I think you could correct that by changing policies in the Eximbank; you should not do it in the Tax Code. It also does away with the yearend scrambling to get qualified assets.

Presently there are practices that you have to have a certain amount of your assets at the end of the year in qualified export assets, so everybody on December 30 goes out and invests in those assets. It is sort of a nonpractical solution to a problem. That is one I would do away with.

I have not talked about services at all, and I did not mean to because we are limited on a topic, but you ought to look at that if you are going to rewrite DISC, because services right now are only covered in an auxiliary nature. They are really not covered in general, and the United States is becoming a service industry, so if you are going to look at this export policy, you may want to look at it.

The other side of the coin is that we are strong at it, and maybe you do not need an incentive, but I think you ought to look at it and address the issues.

There are incremental rules that I talked about, which is basically trying to force companies to increase their exports and only giving them a benefit if you increase it. I think that probably the numbers should be upped again, because of the inflationary economy we are in.

There are numerous other little technical requirements that are in the regulations, and the regulations should somewhere state that, you know, if there is a problem, it is not an all-or-nothing test. Maybe you ought to have a proration test.

Mr. BRITT. Is there any possibility of sort of an umbrella organization that could, you know, sort of cross the "t's" and dot the "i's"

that a number of small businesses could participate in, leaving the technicalities to an ongoing structure, but where you would have groups of small businesses participating in some type of umbrella?

Mr. FOGARASI. Well, I think that is the Export Trading Co. approach, which I think you all had discussed and voted on and put into law. The problem I think you find is that a lot of people are afraid that there is competitive disadvantage when you join hands with your competitor.

I do not know how you overcome that psychological fear. I understand that the New York State Port Authority was thinking of setting up an export trade company and attracting people. I think that may work. We will see. Time will tell how many people you attract to that sort of program.

Mr. BRITT. But you think that that is going to be a major impediment, just the fact of sort of cooperative——

Mr. FOGARASI. Yes; I think everybody likes to keep secret what their pocketbook content is, yes.

Mr. BRITT. No further questions, Mr. Chairman.

Mr. NOWAK. Thank you. Just for the record, Mr. Britt, we are looking at the size of gross sales, gross receipts. I will bring it to everybody's attention here that in 1979, there were 7,208 returns filed, and under $50,000 gross sales, that category constituted 12.8 percent of all those returns.

From the $50,000 to $250,000 category, that also constituted 12 percent. From the $250,000 to the $1 million, that category constituted 23 percent. In the $1 million to $10 million, we had 38 percent of all of those returns filed; $10 million to $100 million, you had 11 percent. Over $100 million, you had 1.9 percent of all those returns.

However, when you try to analyze that in terms of small business versus large business, although you had the 98 percent filing from under $50,000 to $100 million, if you just take the last two bottom categories, those were 1.9 percent of all the returns and 11.7 percent.

If you add and look at the total volume that they constituted of the total gross sales overseas, you come up with the last two categories of approximately 90 percent of all the volume.

So it is very clear that small business does not have a substantial part of that. I think when you analyze those statistics, it is very clear that in that last category alone, over $100 million in sales, only 1.9 percent of the returns had that, and they constituted themselves 65 percent of all the overseas gross business in sales.

Mr. Vandergriff.

Mr. Vandergriff is a new member from Texas and certainly has been one who has been very alert about this problem. We welcome him to the committee.

Mr. VANDERGRIFF. Thank you, Mr. Chairman. I apologize for being late and not hearing all of your comments. That may tend to explain my question in part, but as I listened to what I did hear of your testimony and your responses to questions, I must admit I was reminded of that old joke that I am on the fringes of remembering, something about an old-timer in a community trying to give directions to a stranger who was seeking his way, and the final state-

ment to the stranger that there is just no way to get there from here.

I got the feeling, as I heard you speak, that in your opinion what you are proposing really will not overcome GATT's objections. Did I overreact or would you respond to me on this point?

Mr. FOGARASI. No, I do not think you overreacted. I think what I was trying to make in my introductory remarks, what I was trying to clarify, is that there are two issues here. There is one, there is a legal GATT issue, and there is a political GATT issue.

If you are looking at the legal resolutions, if you set up an offshore entity, you would technically mirror the European system of taxation, which is a territorial concept. That is what the administration was trying to do, set up a system which the Europeans could not argue against because it mirrored their own image. That is on a legal basis.

I was also saying, though, that this is a political issue. It is a political tra issue. If it is to the advantage of the European community to bring up a big hammer over the U.S. Trade Representative's head, they will bring this issue up again, even though you put into law this new foreign sales company approach. If they can argue about substance, they can say, well, you really did not follow all your domestic rules for substance.

By the way, we export our tax laws to the world. Section 482, which is the rule which allocates arm's-length transfer pricing, has been adopted in the European community and, as a matter of fact, most recently, Germany has adopted it. They are now going to argue that if you set up this rule, that really you are distinguishing from domestic rules to foreign rules. You are setting up a different set of rules, and they can argue politically that we are not actually doing the right thing.

Legally, I think we are, but it is going to be a battle anyway. That is all I was trying to point out to you—that it is not going to end after you enact this law.

Mr. VANDERGRIFF. I see. One other question, out of an abundance of ignorance on my part.

How would you, in capsule form, compare the hurdles small businesses in other countries must overcome to do business in our country as compared to the tasks facing ours trying to enter theirs?

Mr. FOGARASI. Well, since I am not really an expert on trade, I will pass that question. That is sort of a very nice leading question, but one thing I could tell you, if you look at the Japanese economy, apparently small businessmen take a great part of that. Because of their export trading companies, they are given a helping hand to export their products all over the world.

So if you want to compare Japan and the United States in small business in both countries, I guess they have an advantage. Even though we have an export trading company bill now, we have it in law, it really does not have any tax incentives. DISC is really the only tax incentive you have in the tax laws for exporting.

If you do away with it, or if you have to give it up, the export trading company legislation by itself will not help you. If you use just that small comparison, I think the Japanese small businessmen have a better advantage.

Mr. VANDERGRIFF. Thank you very much, Mr. Chairman.

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Mr. NOWAK. Thank you. On that last question, what percentage would you say the Japanese are subsidized on their total exports?

Mr. FOGARASI. I have no idea, Mr. Chairman.

Mr. NOWAK. Have you heard 43 percent?

Mr. FOGARASI. You know, I could pick a number, but I really do not have any concrete proof for it.

Mr. NOWAK. All right; thank you very much.

Mr. FOGARASI. Thank you.

Mr. NOWAK. We appreciate your time.

Our next witness is from the Smaller Business Association of New England, Kathleen Hagan. Kathleen is the manager of the foreign trade zone for the Massachusetts Port Authority, or Massport. She is the Director of the Small Business Export program for Massport and has recently completed her M.B.A. from Boston University, another great school.

Kathleen, it is a pleasure to have you and once again, let me just state that your total testimony will be put in the record. You may proceed.

TESTIMONY OF KATHLEEN F. HAGAN, MANAGER OF FOREIGN TRADE, MASSACHUSETTS PORT AUTHORITY, ON BEHALF OF THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND

Ms. HAGAN. Thank you, Mr. Chairman. Good morning, Mr. Chairman, other members of the subcommittee.

I appreciate the opportunity to appear before you today as a representative of the Smaller Business Association of New England—SBANE—on a matter of special interest to the small business community in New England, and in the Nation.

My name is Kathleen Hagan. I am the director of the SBANE-Massport Small Business Export program, which is a unique and nationally recognized export marketing and technical assistance program designed to assist smaller firms in overcoming both the perceived and real barriers to export.

The small business export program began 5 years ago as a joint public/private partnership on the part of Massport and the Smaller Business Association of New England. The Smaller Business Association is a regional association comprised of approximately 2,000 companies throughout New England and representing a wide variety of industries.

SBANE's membership is both export-minded and export-experienced and its international trade committee—SINTRAC—is comprised of leaders in the field of small business export development.

I might add, parenthetically, that the reason that I am here today, and not the president or the executive vice president of SBANE, is that they are in China, trying to develop trade for their companies and their membership. They asked me to represent them. I think the fact that they are in China right now is indicative of the point that I make that I think they are very export-oriented.

The SBANE-Massport Small Business Export program has been remarkably successful because it offers individualized service through the resources of Massport and the SBANE membership to

companies unfamiliar with the subtleties of marketing and selling overseas and confused by the mechanics of exporting.

The experience of the small business export program, and the success of its participant firms, underscore the fact that smaller firms, given the proper technical assistance and financial incentives, can and do successfully compete in world markets.

In light of the risks, costs, and difficulties inherent in doing business in foreign markets, small firms must have clear financial incentives to make internationalization attractive.

The existing tax provision for the Domestic International Sales Corporation is a powerful incentive attracting smaller firms to the international arena.

The financial benefits allowed under DISC provide firms with an opportunity to accumulate funds crucial to the development and support of international business opportunities. The tax alternative to DISC proposed by the administration is clearly well-intended in its expressed attempt to preserve the benefits of DISC for small business; however, the reality is that the DISC replacement proposal, as currently designed, may better suit the requirements of the general agreements on tariffs and trades than it does the real needs of smaller exporters.

Small business recognizes the international reality of the need for the DISC alternative, and the merits of this proposal in a broad sense is a policy alternative. However, the proposal has been met with mixed reviews by the small business community because certain aspects of the proposal are either ambiguous or not suited to small business needs altogether.

The committee would be well advised to carefully review the following questions and problem areas as it deliberates refinement of the DISC alternative proposal: First, for smaller or new to export firms, the establishment of an overseas subsidiary is either financially an imprudent or infeasible alternative.

DISC, as it was originally intended and currently functions, is an incentive to begin export development for small exporters. Only the larger seasoned exporter with a strong foothold on foreign markets can or should assume the financial and business risks of an overseas sales corporation.

Moreover, as a practical matter, is it reasonable to believe that companies can open foreign subsidiaries without subjecting themselves to additional taxes in foreign countries?

Second, with regard to the interest charge alternative, it is unclear as to whether the $10 million sales ceiling mentioned in the administration's document refers to total sales or export sales only. If the former is the case, then the ceiling is restrictive and will be discriminatory with respect to firms that fall in the $10 to $30 million annual sales range, which would quite often tend to be too small to support, at least initially, a foreign sales corporation, and yet too large to qualify for the interest charge alternative.

If the latter is the case, then the definition would be more inclusive and therefore beneficial to small business exporters.

Additionally, the language of the interest charge alternative is ambiguous with respect to new DISC formation. Is this alternative proposed for existing DISCs only? For new DISCs or both?

These distinctions and ambiguities are very, very important to be clarified in any final policy or piece of legislation on DISC alternatives.

Lastly, associating DISC's with foreign joint ventures will enhance the development of U.S. export trading companies in the long-term, but will not suit the needs of smaller exporters now.

The reality is that the formation of successful ETC's in the United States will take some time. Since enactment of ETC legislation last fall, there has been very little activity in the area of ETC formation to date.

ETCs should be viewed as one viable alternative for small business in the future, but certainly not the only alternative as a practical matter now. Timing is a very important consideration in the establishment of alternative export incentives to DISC that suit the present needs of small business.

In a rapidly changing and increasing competitive world marketplace, the United States cannot afford to lose ground by inhibiting both the near term and long range development of the vast export potential of the Nation's small business sector. The economic reality is that small business is big business in terms of the Nation's economic well-being and competitive position in the world marketplace.

The DISC proposal should be viewed, therefore, not only in terms of equity with respect to small business, but also in terms of the Nation's strategic economic interest in internationalizing our industrial base as a whole.

Lastly, the political reality is that Congress and the administration must refine this proposal to make it meaningful and consistent in the benefits to be provided for exporters and yet, at the same time, GATT-defensible.

Mindful of the intrinsic program in balancing the special needs of small business exporters with the international political realities of GATT, the Smaller Business Association of New England stands ready to work closely with the members of this subcommittee as it further develops a viable tax alternative to DISC.

[Ms. Hagan's prepared statement follows:]

PREPARED STATEMENT OF KATHLEEN F. HAGAN, MANAGER OF FOREIGN TRADE, MASSACHUSETTS PORT AUTHORITY, ON BEHALF OF THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND

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and the SBANE membership to companies unfamiliar with the subsidies of marketing and selling overseas and confused by the mechanics of exporting.

The experience of the Small Business Export Program and the success of its participant firms underscore the fact that smaller firms, given the proper technical assistance and financial incentives, can and do successfully compete in world markets.

In light of the risks, costs, and difficulties inherent in doing business in foreign markets, smaller firms must have clear financial incentives to make internationalization attractive. The existing tax provision for a Domestic International Sales Corporation (DISC) is a powerful incentive attracting smaller firms to the international arena. The financial benefits allowed under DISC provide firms with an opportunity to accumulate funds crucial for the development and support of international business opportunities.

The tax alternative to DISC proposed by the Administration is clearly well intended in its expressed attempt to preserve the benefits of DISC for smaller business. However, the reality is that DISC replacement proposal as currently designated may better suit the requirements of the General Agreements on Tariffs and Trade than it does the real needs of smaller exporters. Small business recognizes the international reality of the need for a DISC alternative and the merits of this proposal in a broad sense as a policy alternative. However, the proposal has been met with mixed reviews by the small business community because certain aspects of the proposal are either ambiguous or not suited to small business needs altogether.

The Committee would be well advised to carefully review the following questions and problem areas as it deliberates refinement of the DISC alternative proposal:

(1) For most smaller or new to export firms, the establishment of an overseas subsidiary is either a financially imprudent or infeasible alternative. DISC, as it was originally intended and currently functions, is an incentive to begin export development. Only the large or seasoned exporter with a strong foothold in foreign markets can or should assume the financial and business risks of an overseas sales corporation.

Moreover, as a practical matter, is it reasonable to believe that companies can open foreign subsidiaries without subjecting themselves to additional taxes in foreign countries?

(2) With regard to the interest charge alternative, it is unclear as to whether the $10 million sales ceiling refers to total sales or export sales only. If the former is the case, then the ceiling is restrictive and would be discriminatory with respect to firms in the $10–$30 million annual sales range which would tend to be too small to support initially a foreign sales corporation and too large to qualify for the interest charge alternative. If the latter is the case, then the definition would be more inclusive and, therefore, beneficial to small business exporters.

Additionally, the language of the interest charge alternative is ambigious with respect to new DISC formation? Is this alternative proposed for existing DISC's only? New DISCs or both?

(3) Associating DISCs with foreign joint ventures will enhance the development of U.S. Export Trading Companies in the long term, but will not suit the needs of smaller exporters now. The reality is that the formation of successful ETCs in the U.S. will take time. Since enactment of ETC legislation last fall, there has been little activity in the area of ETC formation to date. ETCs should be viewed as one viable alternative for small business in the future, but certainly not the only alternative and as a practical matter not now. Timing is a very important consideration in the establishment of alternative export incentives to DISC that suit the present needs of small business. In a rapidly changing and increasingly competitive world maketplace, the United States cannot afford to lose ground by inhabiting both the near term and long range development of the vast export potential nation's of the small business sector. The economic reality is that small business is "big business" in terms of the nation's economic well-being and competitive position in the world marketplace. The DISC proposal should be viewed not only in terms of equity with respect to small business, but also in terms of the nation's strategic economic interest in internationalizing our industrial base as a whole.

(4) Lastly, the political reality is that Congress and the Administration must refine this proposal to make it meaningful and consistent in the benefits to be provided for exporters and that at the same time GATT defensible. Mindful of the intrinic problem in balancing the special needs of small business exporters with the international political realities of GATT, the Smaller Business Association of New England stands ready to work closely with the members of this subcommittee as it further developes a viable tax alternative to DISC.

Mr. NOWAK. Thank you very much.

Let me just briefly, before I let the other members take over the questioning, ask a couple of questions on things that have not been focused here.

On the deferred income, can you tell us, in your experience, what happens to that deferred income, to what use is it put by a small or growing business?

Ms. HAGAN. For a small company to begin exporting, there is quite a bit of planning that needs to be done for support costs. When you first get some export sales, you have to anticipate travel on part of the executive, administrative time, recordkeeping. If advertising is involved, there are a whole constellation of support activities that are involved in your domestic plan at home, in terms of helping your organization become service-oriented with its export markets, and at the same time, promoting your marketing efforts overseas.

Those can be quite expensive, and for a small firm, particularly if it is rapidly growing, the cost of money is high. The economy has not been so great in the past couple of years, there are a lot of demands on its resources and so it would have every inclination, if they do not have something like a DISC, to put those resources to their domestic needs. In order to make a little money, you have to spend a little money.

The reality is, there are a lot of demands on what little money small companies have. Although the cash savings are not enormous for a small company, they have to be sizable enough to outweigh the administrative and record-keeping problems inherent in keeping a DISC. Some of the very small companies do not start a DISC at all because—I think it was mentioned in the previous testimony—some of its complexities, if they were simplified, would make it less expensive to manage administratively and therefore, the cash benefit all the greater. That cash could be plowed into modifying your product, if modification is necessary to go into the market, and used for sales expenses for development. It costs a lot to get into a market because you are competing with the other small companies and large companies in their own home turf.

So I just think that it is self-evident that smaller companies, unless they happen to be in a situation where they are throwing off a lot of cash, need cash to develop export sales. This is one indirect way of developing these resources.

Mr. NOWAK. Well, how many of the companies that you have dealt with, if there was not a DISC in place, would not have ventured over into the export sales area?

Ms. HAGAN. I would say 50 percent of them would be put off by not having a DISC. Involved in exporting are psychological considerations, the perceived barriers, as well as the real barriers. They see the aggravation, they see the hassle. Why should they try to learn how to deal with the Germans, deal with the Italians, go over to Singapore, when they still may not have saturated the domestic market? So there is going to be a lot of aggravation. People like myself teach them how to deal with the mechanics, but they still have to make an effort on their part to be successful.

They have to see there is some financial reward in it for them, that there is something in there that will offset that time and aggravation. There has to be a sweetener for them. If they can see

that there is a clear tax advantage to going into export and that they can use the funds generated by that tax advantage to develop export, then it makes export a viable alternative to further expanding their domestic growth.

The firms that I deal with in Boston, are saying to me, "Well, I could go to Seattle and Chicago; why are you telling me to go to Munich? It is easier for me to get on a plane and go to O'Hare; I do not know what I am doing in Germany, and it costs a lot more money."

So they have to have a clear incentive to get into world markets. Many of the companies that I deal with are not inclined to be export-oriented unless they are provided some kind of an incentive.

Mr. NOWAK. I assume, also, it takes an awful lot of time and effort to go through the explanation of what is available, and how to take advantage of your services as well.

Ms. HAGAN. In terms of, it is difficult to get them interested? I think, although many of the companies I deal with have never been east of Cape Cod or west of Albany, N.Y., once they see that there are buyers overseas, they become very interested and they realize that the bottom line is sales. A customer is a customer anywhere.

I think the problem is that with the small firm, with so many other problems in developing the firm, their natural inclination is to defer exporting. They will read in the Wall Street Journal that the dollar is high and that there is a recession in Europe and they will say, I will wait 5 years, when I have got more cash available to get into export; when now may be the very time to get into a market because they may have a worldwide market that is changing rapidly.

Mr. NOWAK. Looking at DISC as one element, or the alternatives that were mentioned, what other types of programs or processes do you think Congress could consider to arrive at a comprehensive export policy? Do you have any thoughts on that?

Ms. HAGAN. I do. My focus today was on DISC. I think the Eximbank could be expanded in such a way that it provides more meaningful services to small companies. That issue may have been before this committee.

I think that there is an effort going on in the foreign commerical service to try to be more service-oriented in aggressively small export companies. I see signs that there are developments.

Congress recently passed the Small Business Export Trade Expansion Act, which was modeled after the Massport program, and I think that continuation and expansion of that program will stimulate other programs such as ours, which are public, in that I work with a public agency, and yet private in that we are closely linked to the business sector.

So I think that expanding the Commerce Department, per se, is not the answer. The answer is incentives in the private sector; whether it be tax incentives or programs directly rooted in the private sector to help assist companies.

Mr. NOWAK. OK, fine, thank you.

Mr. Olin, please.

Mr. OLIN. Thank you, Mr. Chairman. I just have a couple of questions.

Would you say that small business would be better off if we basically stayed with the DISC idea, maybe fixing it up a little bit, or with the administration's suggestions, assuming that we corrected the flaws that you have indicated?

Ms. HAGAN. I believe improvement of the administration's proposal would be preferable even to simplification of the existing proposal because there is a big difference between a tax deferral and a tax allowance. In my opinion, there is potential in this, but the ambiguities that I described make it problematic for small companies.

Although it is not always the case that small companies should not get into setting up foreign sales corporations, there are those that once they get heavily into export, are in a position to do so on a modest scale. The language with respect to what is considered income in that section of the provisions is very ambiguous, and it does not cover services not related to export product, such as management services or selling of software.

In New England, we have a very, very service-intensive economy. A lot of services would not be covered under that description. I think there are some improvements that need to be made overall, but particularly in the small business section, as I mentioned.

Mr. OLIN. Could you just review again for me the difference between the DISC treatment of tax deferral and the administration's proposal?

Ms. HAGAN. Well, the administration proposal, as worded, would pay an interest charge on the tax deferral, but if they were to go into an overseas sales corporation, they would have a tax allowance. So in those cases, it would be beneficial.

I guess my point is that if the proposal were improved overall, the comments that I made about the section relating to the interest charge alternative would be more inclusive for more small exporters, and for those smaller or medium-sized exporters that could set up an overseas corporation, they would benefit from a tax allowance, as compared to a tax deferral.

Mr. OLIN. Could I ask you also, in your experience in dealing with U.S. exporters, could you comment on what you are hearing from them with regard to the amount of Government subsidy that their foreign competitors seem to be getting. How do they view the foreign subsidy situation versus our program on DISC or other things?

Ms. HAGAN. They protest all the time. You take companies to Germany and the German Government is very aggressive with the trade shows, trade fairs. It is true that small companies have to be educated as to how to take advantage of the resources that are available. They have to know how to use the Commerce Department, how to use the Eximbank, and so part of it is a two-way street. However, as a rule, time and again, I have companies call and they are head on in competition with the foreign company, whose Government is going to give them some kind of a direct benefit that we cannot match.

I think that we have to have an export policy overall, and we have to have an export policy that is aggressive with respect to small business development. I think the biggest program is that if this is not dealt with now, it can have a chilling effect on new export development.

That is really my principal point. I mean, obviously we want to continue to keep those who are exporting, by continuing to support them through alternatives such as improved DISC alternatives. There are 300,000 companies in the country, many of them are small, and I am sure you have seen the statistics that in the aggregate, they have very little export activity for the Nation as a whole.

Mr. OLIN. Fine, thank you.

Mr. NOWAK. Thank you.

Mr. Britt.

In your estimation, if the administration's proposal passed as proposed, would any sizable segment of the businesses that you are dealing with today be able to meet those requirements? That is, would they be willing to establish these services overseas to pay those costs—or I guess two questions. One is the existing businesses who might be more inclined because they know whether it is worth it or not, but how much of a chilling effect do you think it would have on new businesses considering export?

Ms. HAGAN. I think it would be chilling, because I think the threat of a problem has the effect of a problem. So even if it is something that could be overcome, they have every reason not to export right now when they do not have a clear incentive. So I think it would be very chilling.

Mr. BRITT. As you said earlier, the perceived impediments are as real in keeping someone from exporting as the——

Ms. HAGAN. I think they have to be faced. If this is refined in such a way that they see clear benefits to them—for instance, there is a bill, I think it is H.R. 1673, Representative Vander Jagt recently introduced, that would set a ceiling on the interest charge to 4 percent for companies whose export sales are $250,000 or less—well, for the tiny exporter who is just beginning to think about it, that is a clear incentive, both in terms of the benefits that would be derived, but in what it sees the Government is trying to do to support it to get into export.

Mr. BRITT. We talked about an overall export policy that would hold forth or hold out incentives to small business, and you talked about the Eximbank; what other measures would you see as major facilitating parts of that policy to encourage small business to export?

Ms. HAGAN. I think the DISC is the most important one right now. As I mentioned, Federal support of independent projects in business communities to make companies more export-aware are very, very important, but I think that the bottom line is that this support is what counts to them.

I think the passage of the Export Trading Company Act was the first clear sign that we are going to have an export policy. You know, the companies that I deal with feel that there is no export policy, that until the oil sharks, we really did not have exports. Now, all of a sudden, Congress is getting very interested in it. The export trading company is going to go a long way before they are formed and it is not for everyone.

I think it was an important first step to allow the banking community to get directly involved in commerce to bring them together. The concept behind that, as the alternative to expanding the

Government apparatus, was to open up the doors in the private sector so as to make financing available.

Financing is crucial. I can teach companies to export until I am blue in the face, but the fact of the matter is that if they cannot carry the inventory for 6 months until they execute the deal, they are goners. So we have a lot of problems with financial considerations. I think the DISC is very, very significant.

Mr. BRITT. I have never seen a small business that did not have a cash-flow problem. If you are talking about front-end investment of something that is unknown, then that is a major impediment.

Ms. HAGAN. Right.

Mr. BRITT. I would like to change the subject for one brief moment because I am very interested in what your organization apparently does. How many States have programs similar to the program that you represent?

Ms. HAGAN. We are the only port authority that has this particular type of program. We are the first ones to be in the program that was exclusively oriented to small business. Many of the port authorities have good trade development programs. The ports of New York, New Jersey, Seattle, et cetera, all have very good programs.

In terms of State governments, a number of States are developing programs because the recently funded Small Business Trade Expansion Act last year funded 10 regional projects around the country to set up projects modeled after the Massport project.

So I would say there are 10 that are in the works. You can go to half a dozen ports and you will find some similar program, and you can go to 10 different States and you will see trade development programs being developed to help small business, but we are really the first ones to have this formalized program that I know of.

Mr. BRITT. Do you have statistics that would show the success or the increase in exports?

Ms. HAGAN. Well, we have two levels of service and we have helped hundreds of companies in a smaller way, but in a larger way, of the ones that went on trade trips to Europe, some 60 companies, had $10 million in sales. We have other ways of measuring the benefits to the other companies, but we feel it has been successful.

We feel that they are not stupid. They may have been to Europe once or twice before, or been to the Orient once or twice before, but once they are shown the way, they are certainly willing.

The fact that they are entrepreneurial and willing to be successful and work hard in the domestic market, once the exporting process is demystified for them, they are very aggressive.

Mr. BRITT. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you. Mr. Vandergriff.

Mr. VANDERGRIFF. I appreciated Mr. Britt's questions, and your responses, giving me a better grasp of your department, your organization. Do you have any idea about the total volume of overseas business that your member firms might be doing? Do you have any statistics in that regard?

Ms. HAGAN. That $10 million figure is the recent figure. You mean in terms of all the firms that we deal with in the aggregate in New England?

Mr. VANDERGRIFF. Yes, I was just curious.

Ms. HAGAN. We do not track that as a rule. We do not require that the companies we work with indirectly give us their sales figures, and there is a certain amount of proprietary information involved. Most of them are very forthcoming about information but we respect and understand their reasons for not wanting to divulge some data.

If they are making a lot of money, sometimes they do not want you to know, and if they are losing money, they do not want you to know. So, in terms of the aggregate, I would say we definitely see a trend in New England with small business exports. Exports as a whole have doubled in New England in the past decade.

They have gone up 400 percent in the past 20 years. A large percentage of that is smaller exporters getting into the market. So we see aggregate figures that are a clear indication that smaller companies are expanding, particularly because our industrial base consists mainly of technical and high-tech companies of innovative products. We can track in the general sense what is going on in terms of trade flows, but in terms of the companies beyond the trade missions, I do not require that they give me their financial information, and they would not necessarily provide it.

But they are doing well. The ones that get into it, I think, as rule, do well. If we have educated them enough so they make a prudent decision that they should not be in exporting right now, we have saved them 5 years worth of aggravation and now they have other opportunities open to them.

So I think the point of a program like ours is to educate all of the small business sector to the alternative of exporting so that they can explore it judiciously and then, for those that are suited and are ready, that they can know in what manner they should go. Should they go directly or indirectly; should they join a trading company or go on their own?

But it is not for everyone. Companies on their own might not know how to qualify themselves for export because they just do not have the experience.

Mr. VANDERGRIFF. Well, I certainly commend you for your leadership in this field.

Ms. HAGAN. Thanks.

Mr. VANDERGRIFF. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you. I just want to add, we may be calling on all our witnesses in the future to get some deeper background and perhaps some broader experiences from some specific companies that you have been involved with.

Let me congratulate you on being a leader in this field and certainly looking at this program, I think, in a very realistic way. Hopefully, we will get a comprehensive program which will include financing perhaps a little larger share of the Export-Import Bank dollars that go out for small business.

There has been some conversation that at least 20–25 percent of those dollars should be also set aside for small business, which would give us, I think, a better handle for that cause.

If that were the case, you would see some of the figures that I recited earlier about the types of sales and the percentage of gross receipts that are out there on the DISC which are to have a reverse

effect, and perhaps we could get more active smaller companies involved.

Again, thank you very, very much, Kathleen, for coming down and taking the time to be with us.

Ms. HAGAN. Thank you, Mr. Chairman.

Mr. NOWAK. Our next witness is the U.S. Chamber of Commerce, the Small Business Council, Evan A. Werling, who is vice president of finance for French Oil Mill Machinery Co., in Piqua, Ohio.

Prior to joining the company 4 years ago, he worked as a certified public accountant and Mr. Werling is a member of the chamber's small business expansion task force and its broader export policy task force.

It is a pleasure to have you here.

TESTIMONY OF EVAN A. WERLING, VICE PRESIDENT OF FINANCE, FRENCH OIL MILL MACHINERY CO., PIQUA, OHIO, ON BEHALF OF THE SMALL BUSINESS COUNCIL, U.S. CHAMBER OF COMMERCE; ACCOMPANIED BY RACHELLE BERNSTEIN, SENIOR TAX ATTORNEY, U.S. CHAMBER OF COMMERCE

Mr. WERLING. Thank you, Mr. Chairman. I want to say, first of all, that it is very gratifying to see the number of committee members present because this is a very important issue facing small business.

First off, I would like to say that French Oil is a family-owned company in Piqua, Ohio. We are a small company; we employ approximately 250 employees. We do have a DISC corporation, and approximately 50 percent of the products that we manufacture are exported. We are 83 years old, and of the products that we export, the primary products are not petroleum related. We manufacture equipment that extracts oils from vegetable seeds; for example, corn, cottonseed, flax seeds, sunflower seeds, and so on, throughout the world.

With me today, on my left, is Ms. Rachelle Bernstein, the senior tax attorney for the U.S. Chamber. She did a very extensive job in assisting with today's presentation.

I would like to submit for the record my prepared testimony, and basically summarize the testimony, along with some of the comments that have been made today.

On behalf of the chamber of commerce, I would like to say that approximately 85 to 90 percent of our membership consists of small business. This issue is a very, very important item for small business in the U.S. Chamber.

The Small Business Administration, in a report issued in September of 1982, reported that there are approximately 20,000 and 30,000 small manufacturers, either presently exporting in the United States, or who have had some previous exposure to exporting.

The unfortunate thing is there are also an additional 20,000 to 30,000 small manufacturers, not counting all the other small businesses that could be exporting, but small manufacturers alone, an additional 20,000 to 30,000, that are not exporting at all. There are a number of reasons for this.

I think that in the last few years, with all the Federal Government studies that have been going on, we have pretty well come to a consensus as to why more more small businesses are not exporting.

The four primary reasons are: Lack of information on how to export, and that is a very significant problem, but it can be overcome. No. 2, many small manufacturers and other small businesses consider the regulatory requirements very complex and difficult to deal with.

One of the very important problems a small business has is the difficulty in obtaining competitive export financing for their products.

Last is what is perceived, and I think this is, to a great degree, an optical situation, although I think it does exist in some situations, they perceive a lack of cooperation from U.S. Government organizations, both domestically and internationally. I would like to say that my company's experience has not found this to be true. We have found extremely good cooperation from our U.S. Embassies abroad and also from our departments here in Washington.

That is still a perceived problem by small business, and so we cannot ignore it as a problem. But in the past 2 years—I realize we are talking about DISC legislation here as an export incentive, but for the past 2 years, small business has virtually been driven out of the export market but of the lack of competitive export financing.

I will say this. If you do not have competitive export financing as a basis for small business, we are asking them to compete against foreign governments and small business cannot do that.

Over the past 2 years, not only has small business been driven out of the export market, but what has happened is that many small companies, such as the French Oil Machinery Co., have found their volume dropping off extensively, not because orders are not there, but we could not provide competitive financing.

This, in turn, puts the parent company into a loss situation, and so what happens? In order to keep the parent company functioning, we have to transfer accumulated DISC benefits from the DISC over to the parent and so then you start taxing a loss corporation because you are forced to transfer the accumulated DISC benefits over to the parent company to keep it going.

So small business has really been hit with a double whammy in the last couple years and those exporters like ourselves who have developed an extensive export market have just been devastated by the lack of competitive export financing.

Now we are confronted with the situation where the existing DISC regulations are not GATT compatible. Well, if we keep going much longer the way we are, it will not make much difference because we will have transferred all of our accumulated DISC benefits back to the parent and will not have any benefits from the DISC corporation.

But in any event, under the administration's proposal for a GATT substitute for the DISC, they have laid out four specifications that must be achieved: No. 1, it must be GATT legal; No. 2, it must be revenue neutral; No. 3, it must not produce any new taxes, and that includes on small business; and No. 4, it must be usable by small business.

In the past, I have been working with the U.S. Chamber, the National Federation of Independent Businesses, the National Association of Manufacturers and some other small business organizations regarding this issue and also the Export-Import Bank.

We have also had a meeting with the U.S. Trade Representative's Office regarding this issue. I want to say this: We are extremely appreciative of at least the interest and the intent the administration has in making sure that small business does not get hurt by these revised regulations.

However, I would have to say that after working with all of these small business groups, we have come to a consensus that with the existing proposals on the table to replace the DISC, without exception, we all concur that, first of all, these regulations are either not going to be easily implemented by small business, or they are going to end up creating a tax increase for many, if not most, small manufacturers who presently have a DISC corporation.

When the gentleman from Arthur Andersen was testifying this morning, and I thought he did an excellent, excellent job, one of his comments was that he did not see, really, as a good usable tool, the opportunity for small business to join into an offshore venture with other companies. One of his comments, which is very, very true, and I would like to emphasize, with the existing proposed regulations, small companies are going to have to disclose sales prices and marginal contributions, in order for an association to allocate back to the small manufacturer or the small company his portion of the tax deferral.

Small manufacturers are not going to be willing to do this, to disclose their financial information by a product-line basis or product basis, as well as for their overall exports. It just does not appear to be a viable alternative.

I think from an encouraging point of view, the U.S. Trade Representative's Office, and the administration, have expressed a very strong desire and willingness to help us come up with an acceptable alternative, but I do not think we are there. I definitely do not think we are there.

In appendix 3 of the formal proposal we have given today, we are making a recommendation that pertains to the free trade zones, or foreign trade zones, as explained by Arthur Andersen.

We have discussed this with numerous small business associations and based upon all of the alternatives that we are aware of, this appears to be a very viable option that we should consider. We are faced—and incidentally, in appendix 3, we have a very detailed layout of how we think it might work. It would not present an overburdening problem for small business, and it would not present a tax increase for small business.

In fact, if we could make this option work, it would be a much better vehicle that what we have with current DISC regulations. The present DISC legislation certainly is not utopia for small business. We have far too many problems with it.

We have not explored all the ramifications regarding the free trade zone or foreign trade zone concept, but I would like to say that the U.S. Chamber and I are more than willing to work with this committee and your staff to find out whether or not we can explore this avenue further and make it workable for small busi-

ness because at the present time, the administration's proposal does not appear to be a viable solution for small business.

One of the interesting comments I heard this morning was, how does the United States stack up in relation to the foreign competition, foreign government, in supporting small business exports? I have been testifying quite a bit regarding the Eximbank charter renewal, and it has been hitting the paper a little bit. Just this week, before I came to this committee hearing, I received a phone call from a European representative, based in Ohio, saying, look, we recognize what your problem is, we know that the problem is with the Export-Import Bank, we would be happy to show you our program over in Europe, which is very substantive from a support standpoint for exports.

We can reduce your taxes; we can assure you of consistently competitive export financing. Would you be willing to talk to us about the possibility of moving your export operations over to Europe? That happened this week. And this is not unusual.

Our country is really, really behind. We play by the rules of the game that we would like to see the rest of the world operate by; but we are not waking up to the real world and playing the game the way they play it. We are losing out, and we are losing a lot of jobs in this country because of that.

As far as small business is concerned, I think everyone in this room recognizes that small business is the only major resource we have in the United States where we can significantly enhance employment through the expansion of exports. We have hundreds of thousands of small businesses in the United States who have the potential of getting into the export market but are not exporting today.

Big business cannot create the kinds of jobs that small business can. Unfortunately, we are losing the existing jobs that we have had in the export market. We are not looking at going forward right now; we are looking at trying to salvage an existing very bad situation, let alone go forward.

Consequently, any new legislation that is enacted regarding the DISC corporation has got to be usable by small business, and I mean really usable.

Second of all, it has got to truly not create any new taxes. If we can accomplish that, these 20,000 to 30,000 small manufacturers that have shied away from the export market, once they can find out that the Federal Government is really going to be supportive, both from a financing standpoint and from a tax legislation standpoint, I think we are going to find a much, much greater interest by small business toward exports.

It is in the interest of small business to really become involved in the export market because we are living in a world economy today, and small businessmen recognize that. If we do not become involved more effectively in the export market, we are going to find out that the domestic market we have is no longer our domestic market.

We are finding foreign competition coming into our market every day, so it is an opportunity not only to expand the profitability of small business, or to maintain the profitability of small business, but also to make sure that our technology is keeping up with what

our foreign competition is doing. Unless we are involved in the international marketplace, we are going to find out too late that our technology did not keep pace, and pretty soon we are going to find out that we do not have our domestic market.

We are losing domestic market because of foreign financing subsidies that we cannot compete with. So the DISC legislation, although it is extremely important, unless we solve some of these other problems, I guess it becomes almost irrelevant what happens to the DISC legislation, because we will not be able to compete on the export market anyway.

That concludes the formal presentation that I would like to make, but there were several questions that were raised by the committee that I would like to take just a few minutes to address.

That is, what is the most important thing the U.S. Government can do to help small business in the international area? First, I think one of the most important things that can happen is for the U.S. Government to consolidate the numerous, numerous agencies that affect small business in the export market.

We have an Eximbank, the Small Business Administration, ITA, U.S. Trade Representative, and on and on and on. This is just an incomprehensible maze for small business to try to pull together information on the many, many fragmented segments of the Federal Government that affect their efforts in the export market.

This is probably one of the most important things that can be done. But even if we do that, second, unless we can assure that when the private capital markets are not competitive with financing—and let's face it, small business has no control over the private capital markets. The Federal Reserve System controls interest rates in this country, and when the Federal Reserve pushes interest rates in the private capital markets out of line with what the foreign governments are supporting through the OECD arrangement, small business has no place to turn but to the Eximbank. If the Eximbank is not going to pick up the position of providing competitive export financing, which they have not done in the past 2 years, small business finds itself pushed out of the export market.

In that kind of an environment, small business cannot afford the risk of getting involved in exports, as we have with about 50 percent, only to find the rug pulled out from under us because of changing politics.

I mean, that is a basic foundation that has to exist if small business is to ever take the risk of trying to develop the international marketplace.

I think, third, we have got to take a very close look at the Foreign Corrupt Practices Act. I think, again, here is a situation that has a lot of good intent behind it, but it also represents the moral and philosophical views of the way we live in the United States, and does not represent export trade in the real world.

I think it really is tying the hands of a lot of American companies to keep jobs in the United States, and let's face it, when we talk about exports, when we talk about DISC and we talk about Exim or anything else, we are talking about jobs in the United States and ways to keep jobs in the United States, and second of all, ways to prevent more U.S. companies from transferring their operations overseas.

So those are three things that I think are very, very important. I am not a proponent of keeping the existing DISC structure, because it is too cumbersome for small business. The yearend complications really—that is one of the most mentally taxing parts for a small manufacturer, waiting until the end of the year to see whether or not he is qualified as a DISC or whether he has lost all of his benefits.

The rules on producers' loans are too restrictive, so small business does not get the benefit out of existing DISC legislation that big business does. They do not have the capability of doing that.

However, the importance of DISC, I think, cannot be understated. We are talking about meeting the foreign competition to keep jobs in the United States, and not just to keep jobs here, but to expand employment. I think that is what we are really looking at as far as the bottom line is concerned: employment.

As far as what do small companies do with the benefits of DISC, right now we are paying taxes because we are losing the benefits from it. To give you a good example of what we have to do with it; whenever we sell capital equipment overseas, we have got to maintain an inventory of repair parts, so we have got to be able to maintain inventories, which also create new jobs in the United States, to support those products we have overseas. It is very expensive for small business to develop new markets overseas.

One of our vice presidents is traveling to Pakistan; in fact, he left Sunday. That trip alone is going to cost our company somewhere in the vicinity of $5,000 to $7,000. That is very, very expensive for small business. This is just to investigate a prospect, not a definite sale.

I do not consider the DISC a subsidy for small business at all, it is an absolute necessity to allow us to compete with our foreign counterparts.

Thank you very much for the opportunity to be here today.

[Mr. Werling's prepared statement with attachments follow:]

PREPARED STATEMENT OF EVAN A. WERLING, VICE PRESIDENT OF FINANCE, FRENCH OIL MILL MACHINERY CO., PIQUA, OHIO, ON BEHALF OF THE SMALL BUSINESS COUNCIL, U.S. CHAMBER OF COMMERCE

Mr. Chairman, members of the Subcommittee on Tax Access to Equity Capital and Business Opportunities of the House Small Business Committee, I am Evan Werling, a member of the Export Task Force of the Small Business Council of the United States Chamber of Commerce. Accompanying me today is Rachelle Bernstein, Senior Tax Attorney for the Chamber. I am the Vice President of Finance for the French Oil Mill Machinery Company, which is located in Piqua, Ohio, a community of approximately 20,000 people. French Oil is a small family-owned company (employing approximately 250 people) which exports approximately 50 percent of its sales volume. Our company designs and manufactures machinery used in the extraction of edible vegetable oils (such as soybean oil, corn oil, sunflower oil, etc.), separation of water from sugar cane, dewatering of natural rubber and synthetic polymers as well as in the molding of rubber into various products, from tennis balls to automotive engine gaskets.

On behalf of the U.S. Chamber of Commerce, 35 percent of whose members are small businesses, we welcome the opportunity to testify on the use of DISC and export incentives by small business. Export expansion can play a vital role in stimulating this country's economic recovery. Exporting American goods and services makes our economy productive, raises income and provides a higher tax base at federal, state and local levels.

The Small Business Administration estimates that approximately 20,000–30,000 small manufacturers are capable of exporting but do not. Many small businesses are

unaware of the possibilities exporting can offer them, or are reluctant to get involved in what they perceive as a complex and complicated process.

I. THE ROLE OF SMALL BUSINESS IN THE EXPORT MARKET

Over a number of years, the small business community has made it clear that while export possibilities interest them greatly, they are generally intimidated and/or overwhelmed by the process.

Reports, hearings and surveys by both Houses of Congress, the General Accounting Office, the U.S. Chamber and various other groups all indicate that small businesses perceive several obstacles to exporting. These include:

Lack of information; complex and lengthy regulatory requirements; difficulty in finding competitive financing for export activities; and lack of assistance and cooperation from government representatives here and abroad.

A. Lack of information

In a 1980 survey by the Senate Small Business Committee on obstacles to small business exporting, lack of information was the problem cited most often.

Small business owners do not have the resources to conduct research on prospective markets, profit potential or feasibility, whereas larger firms may be able to devote entire departments to do such activities.

Government has a role to play in seeing that potential small business exporters have easy access to information on prospective foreign buyers, foreign and domestic regulatory and available government services.

Existing channels of communication in the Department of Commerce, the Office of the U.S. Trade Representative, the Export-Import Bank, commercial banks, state and local governments, and trade associations all could be useful in getting the word out to potential small exporters.

B. Regulatory requirements

Regulations, both foreign and United States, pose another major obstacle to small business exporting.

The expense, time, expertise and paperwork required to comply with lengthy and complicated regulations are beyond the limited means of most smaller firms.

Licensing requirements in many cases are a hindrance. The time involved in getting a license to export may cause smaller firms to lose business because they cannot respond quickly enough to buyer requests.

Simply determining whether a product requires a license to export is nearly impossible for small businesses that are unfamiliar with exporting regulations. They are intimidated by lenghty and bureaucratic regulatory prose and cannot afford to hire outside expertise to decipher these regulations.

C. Competitive financing

Many small firms that have explored opportunities find that the banking community is not attuned to small business needs.

Smaller firms have difficulty obtaining competitive financing and frequently encounter delays in processing letters of credit.

Recently authorized loan guarantee, discount loan and medium-term credit programs established in the Export-Import Bank and Small Business Administration are a positive step forward. However, unless Eximbank medium-term programs are made fully competitive, on a consistent basis with the programs supported by the governments of our foreign trade competitors, small business will not be able to assume the risk of allocating significant resources and management effort toward development of the export market. Every effort should be made to see that these programs are well-publicized and easily accessible. Hopefully, as the demand for small business export financing grows, more financial institutions will begin to tailor their services to this growing and increasingly important market.

D. Lack of assistance and cooperation

Many small exporters decry the lack of coordination between various government agencies regarding requirements and procedures for exporting. Some perceive U.S. Embassies, Consulates and Trade Commissioners as biased toward larger companies that can bring the United States far greater revenue than smaller firms.

Small business collectively has the potential to bring added billions of dollars of revenue and millions of jobs into our nation's economy. Individually, small firms need to feel that their importance is acknowledged by the government. Sensitivity

to small business needs and concerns in export matters is essential for U.S. representatives, both here and abroad.

Trade missions and fairs organized and sponsored by the Commerce Department are especially useful in familiarizing small businesses with export processes and possibilities and in matching them with potential buyers and agents abroad. The opportunity for individual assistance and attention is very important for small firms.

The Commerce Department, as well as other public and private groups, should continue to sponsor these events and to encourage small businesses' participation.

II. DISC AND EXPORTS

Although small business does not play a large role in the U.S. export market as they should, they do make substantial use of the export vehicles already in the law. According to the most recent Treasury Department report on the Domestic International Sales Corporation (DISC), 85 percent of the companies using DISC have less than $10 million a year in export sales. Thus, the vast majority of DISC users are small businesses.

The Treasury Department Report estimates that DISC will induce additional exports valued between $6.2 and $9.4 billion. DISC increases exports by making major inroads in eliminating the competitive disadvantage which U.S. business suffers vis-a-vis their trading partners who have the benefit of more advantageous systems of taxing exports and other governmental subsidies. Higher levels of exports benefit all Americans. Higher exports provide added job opportunities. The additional sales mean higher incomes for workers, suppliers and business investors. Expanded output lends to lower per-unit costs for many industries, which translate into lower prices for domestic as well as foreign purchasers.

A recent Conference Board study showed that four out of every five U.S. manufacturing jobs created between 1977 and 1980 were export-related. In the short run, the additional exports that DISC generates serve mainly to put idle workers and capital back to work. In the long run, a reduced tax rate in the export sector means there will be additional funds attracted to that sector. Some funds will come from import-competitive industries, some from new domestic investment, and some from foreign investors, resulting in a net gain in capital. The additional capital in turn produces a net increase in output and employment. Thus, it cannot be said that DISC merely moves jobs from import-competitive to export firms. Moreover, DISC encourages multinational firms to manufacture goods in the United States instead of abroad, thus creating more jobs in U.S. plants.

A. The DISC replacement

At the October 1982 meeting of the GATT Council, U.S. Trade Representative William Brock announced that the Administration would propose an alternative to DISC because of compliants made by members of the Council that DISC violates the General Agreement on Tariffs and Trade (GATT). In defining the parameters of the DISC alternative, the Administration has repeatedly stated that the substitute must be GATT-legal, avoid any tax increases for exporters, be revenue neutral, and be usable by small business.

Any replacement for DISC must be devised through the Internal Revenue Code. DISC was designated specifically to remove the uncertainty and inflexibility of subpart F and the Section 482 intercompany pricing rules[1] which encourages U.S. companies to turn to foreign manufacturing or to foreign suppliers to avoid the extra-territoriality and complexities of U.S. tax law and apprehension over possible double taxation. Therefore, even if a non-tax alternative were designed which overcame the disadvantages of the extraterritoriality of U.S. tax law, it would not eliminate section 482 problems.

Prior to the enactment of DISC, the section 482 regulations caused exporters of goods manufactured in the United States to become involved in lengthy and extensive disputes with the Internal Revenue Service (IRS) over sales to foreign affiliates. DISC resolved this problem by creating a definitive rule for allocation of profits between the U.S. manufacturer and its DISC. A non-tax alternative to DISC would again result in an enormous number of section 482 cases which would bog down the IRS and be very costly to the exporter. This would serve as a great disincentive to U.S. manufacturers who export their products since many small businesses lack the in-house staff capability to deal with the IRS.

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[1] Section 482 of the Internal Revenue Code provides complicated rules by which a company must prove that an arm's length transfer price was used.

1. *Administrative proposal.*—The Administration released an outline of its proposal for a DISC replacement on March 9, 1983. Under the proposal, a foreign sales corporation (FSC) would be incorporated outside U.S. territory and a portion of the FSC's income from export sales would be exempt from U.S. tax if it conducted economic activities outside the United States. The amount of the FSC's income which would be exempt from tax would be dependent on using arm's length transfer pricing principles to determine the price at which the export property was transferred from the U.S. manufacturing to the FSC.

Under the proposal as a matter of administrative convenience, the arm's length requirement could be met by utilizing an administrative allocation rule provided that the FSC performs certain activities described in Appendix 1. The rule would be satisfied by an allocation equal to the greater of: (a) 17 percent of the combined taxable income earned by the U.S. manufacturer and foreign sales corporation; or (b) 1.35 percent of the foreign corporation's gross sales, but not to exceed 34 percent of combined taxable income.

As an alternative to the administrative allocation rules, taxpayers could determine the allocation of income between the parent and FSC by using a transfer price determined under Section 482 of the Code.

The Administration's proposal goes a long way in simplying the rules under DISC. Although the majority of taxpayers using the present DISC provisions are small business, many small business exporters are not using DISC simply because the rules are too complicated. The proposed elimination of the present rule requiring that tax deferred income under the DISC be invested in certain qualified export assets is particularly important for small business because it allows these companies, which have more difficulty in obtaining competitive financing, an unrestricted source of capital. Equally important for small business is the elimination of another complicated rules and regulations that, if not met, might cause the small businessman to unwittingly terminate his DISC status.

Although the taxing rules under the Administration's FSC proposal are simpler than under the present DISC rules, the basic concept of requiring a foreign corporation which must perform certain economic activities outside the United States causes additional burdens for small and larger businesses.

Any proposal which is drafted to replace the DISC must not be so costly as to reduce the present benefit to DISC users, nor must it require such extensive overseas operations as to cause the export of jobs. Recognizing that the requirements of the proposed FSC might be too costly and complicated for small businesses, which do not have extensive operations outside the United States nor the capability to oversee such operations, the Administration has proposed two alternative options for small business.

(a) Interest Charge Alternatives: Under the option, exporters would be allowed to continue to operate their DISC's for sales of up to $10 million, and an annual deductible interest charge would be imposed on the value of the tax deferral at the Treasury bill rate.

It is difficult to perceive how small business would not lose any of its present DISC benefits under this option. Since the only value of a tax deferral is the time value of money, paying an interest charge on that deferral would eliminate its benefit. In this case, the value to small business of this proposal would be the difference between the Treasury bill rate at which they would be paying interest (8.7 percent on April 4, 1983) and the cost of borrowing money (approximately 1.5 points over prime, or 12 percent). Complications in the approach could arise because of the constant fluctuations in interest rates.

Deferral is more valuable to firms that derive more of the income from export and to one that face high borrowing cost than to companies for which exports are small compared to domestic sales or which can borrow at small premiums over the Treasury rate. Consider three companies with the same total sales and tax rates but different ratios of domestic to export sales. Firm A's exports equal 10 percent of total sales. It will not benefit at all from deferral compared to a 17 percent exemption. Firm B, with equal domestic and export sales, will choose deferral only if its cost of borrowing it at least 1.5 times the Treasury rate (e.g., over 12 percent when the Treasury rate is 8 percent). Firm C, for which exports equal 90 percent of total sales, will be better off choosing deferral if it can borrow at as little as 1.25 times the Treasury rate (e.g., 10 percent when the Treasury rate is 8 percent). Thus, deferral provides the most benefit to export-oriented business with good credit ratings.

Most important, this approach will not come close to giving small business an equal benefit to what they are receiving under the present DISC rules. Now, small business is essentially receiving an interest free loan on 42.5 percent of their net taxable DISC income. Under this approach, small business would be receiving an 8.7

percent loan on 100 percent of their taxable income. Therefore, the only way in which a small businessman would receive equivalent benefits under this rules if he can receive at least a 15.1 percent return on his investment. This type of return becomes more and more improbable for small business in today's economic environment.

This approach will also cause problems for small business because, as deferred accumulates over the years, larger and larger amounts of interest on these deferred taxes will become due, and at some point these annual interest charges could surpass a small business user's annual DISC income.

b. Joint participation: Under this option, several corporations could join together to form a foreign sales corporation. The joint participation could extend to usage and ownership so that participants would receive distributions on a patronage basis.

The major problem with this approach is that small business does not like to give up control of any aspect of conducting their business nor are they receptive to disclosing information on the sales price and cost of their products. This may be the reason why there are few, if any, multiple DISCs, even though they are permitted under the present DISC rules. Whether this option could work at all depends on how much of a foreign presence would be required of this multiple entity. Requiring an offshore office and a foreign director would probably work, but anything else would necessitate rules which would allow the entity to contract back to each small business shareholder for performance of services related to its exports in the United States. However, some type of joint participation option should probably be included with whatever alternative DISC legislation is finally proposed.

Encouraging small businesses to enter into the export market is important for the growth of the U.S. economy. This is being done already by the Commerce Department through its promotion of the export trading company concept. If export trading companies could also provide small business the opportunity to use FSCs, they might attract more small businesses into the export market.

2. *Other small business options.*—a. Utilization of Free Trade Zones: The major problem for small business with the Administration Foreign Sales Corporation proposal is that many economic activities are required to be performed outside the United States. For purposes of the Administration's proposal, they define "outside the United States" as outside the customs territory of the United States, since this is the definition of territory which is used in the GATT. Free trade zones, which are located throughout the United States (in port areas, international airports, etc.), are considered to be outside the customs territory of the United States. Allowing small businesses to conduct the activities which are required to be performed outside the United States under the Administration's proposal from these free trade zones might eliminate much of the burden of the FSC concept while still being defensible under the GATT. However, use of the free trade zone concept would only work if the activities required to be performed in them were minimal in effect. Small business should not be required to move substantial operations to free trade zones. This would be almost as difficult as moving their operations overseas. We, therefore, suggest that these activities be interpreted as in the Clarification of FSC Requirements, included in Appendix 2.

If this approach were adopted for small business, the administrative allocation pricing rules under the Administration's proposal would also have to be modified to provide small business with benefits equivalent to those that they presently have. The pricing formula under the proposed administrative allocation rules does not take into account the fact that small business was not subject to the incremental rule under the present DISC rules.

Appendix 3 outlines this Small Business proposal for DISC Replacement.

b. Small business exemption: Requiring small business to incorporate overseas and carry on substantial economic activities outside the United States is not practical because of the physical and financial burdens which would be imposed. Although small business constitutes a majority of DISC users, they receive only a small portion of total DISC income (85 percent of all DISC users have gross receipts under $10 million and receive only 12 percent of total DISC income). Therefore, if an exemption were provided for small business it would be de minimis and should not offend GATT members. Furthermore, any charge of damages made by GATT members would be difficult, if not impossible, to prove. Because of the minimal amount of DISC income earned by small business, it would be difficult to prove that any harm had been incurred.

Another possibility would be to require that small business incorporate overseas but not be required to perform any economic activities outside the United States.

CONCLUSION

It is essential that any DISC alternative proposed for small business not create overly burdensome paperwork requirements or be so costly as to reduce the benefit presently received by small business DISC users. We also urge Congress and the Administration to continue working on ways to aid small business involvement in the export market because of the significant role exports play in expanding our economy.

The Chamber has examined all of the alternatives for DISC use by small business proposed to date and finds that none of them meet the prescribed criteria of being usable by small business and creating no tax increases for small business. We, therefore, recommend that the concept of using free trade zones be explored further to see if it will comply with the criteria of revenue neutrality, GATT legality, creating no tax increases, and usable by small business. We would be happy to work with Members and staff of this Subcommittee in developing a DISC replacement viable for small business.

[Appendix 1]

REQUIRED ACTIVITIES OF THE FOREIGN SALES CORPORATION

To be eligible for tax exempt treatment under this proposal, the foreign sales corporation must: (1) maintain an office outside the United States; (2) maintain books and records in that foreign office;[1]

In addition, to be eligible for the administrative income allocation rules the following functions must be performed by the foreign sales corporation, or for it on a contract basis, in connection with foreign trading gross receipts: (5) solicit orders from the negotiate contracts with customers; (6) process customer orders; and (7) bill customers and receiving payments.

Furthermore, to be eligible for the administrative income allocation rules the foreign corporation must engage in foreign economic processes by satisfying the following three categories of requirements.

Category 1: The foreign sales corporation must participate outside the United States in the solicitation, negotiation, or acceptance of sales. Solicitation including advertising, direct mail, or other communications to related or unrelated customers or potential customers. Negotiation includes any communication relating to terms of sale. Acceptance means formal legal acceptance.

Category 2: The foreign sales corporation must perform outside the United States activities that give rise to 50 percent of the costs associated with items 1–5 below, or do substantially all (85 percent) of two of the following: (1) process customers orders; (2) bill customers or receive payment; (3) engage in adverstising and promotion activities; (4) contract for payment of commissions or fees to related or unrelated agents; and (5) assume credit risk, risk of loss from casualty, damage, etc., and foreign exchange risk.[2]

Category 3: The foreign sales corporation must perform substantially all (85 percent) of the following activities outside the United States: (1) Hold board of directors and shareholders meetings; (2) maintain a separate bank account and paid in capital; and (3) disburse dividends, legal fees, board of directors and officers salaries, and accounting fees.

Where the U.S. exporter or the foreign sales corporation sells to a related foreign buyer, the activities in categories 1 and 2 above relate to transactions between the seller and the related foreign buyer.

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[1] For purposes of U.S. tax administration and enforcement, it will be necessary for the books and records to be available for examination in the United States. (3) have at least one resident director outside the United States; and (4) hold an exclusive or non-exclusive agency agreement, franchise agreement, or distribution license with respect to the product.

[2] The assumption of risk implies an additional burden or gain for the foreign corporation than that implied by the normal calculation of combined taxable income. If a foreign corporation chooses to incure these additional risks an additional adjustment will be made to the income allocated to the foreign corporation to derive that portion of the income that will be exempt from tax. The adjustment will be the subtraction from the foreign corporation's income allocation of 17 percent of all the losses incurred by the related parties resulting from these risks, and the addition to the foreign corporation's income allocation 17 percent of all the gains for the related parties and incurring foreign exchange risk.

[Appendix 2]

CLARIFICATION OF FSC REQUIREMENTS

I. Eligibility for Tax Exempt Treatment Requirements—All FSC's must satisfy these requirements. 1. Maintain an office outside the United States (a) May be on shared basis with other entities (b) Need not satisfy permanent establishment test and:

(c) Need not be in country of incorporation or in country where business is being conducted

2. Maintain books and records the that foreign office (a) May be summary books and records

(b) Need not be original books of record or entry and (c) need not maintain back-up documents

(3) have at least one resident director outside the United States:

(a) May not be resident of United States

(b) May be resident of any foreign country

c. Does not have to be resident of country of incorporation or country where business is conducted; and 7

(d) Need not be an employee of the FSC.

4. Hold an exclusive or non-exclusive agency agreement, franchise agreement, or distribution license with respect to the product:

(a). Applies only to purchases of products from related entities

(b) May be signed at time of sale and may be terminated at will.

II. Administrative Income allocation rules—FSC's not wishing to use present section 482 rule must satisfy these requirements.

The following requirements may be satisfied within or without the United States. To be eligible for the administrative income allocation rules the following functions must be performed by the foreign sales corporation, or for it on a contract basis, in connection with foreign trading gross receipts (5) solicit orders from and negotiate contracts with customers; (6) process customer orders; and (7) bill customers and receive payments

Subject to the requirements of categories 1, 2, and 3, the United States related supplier may perform these activities in the United States on a contract basis. Thus, a simple contract provision between FSC and related supplier providing that parent directly and through its affiliates will perform 5, 6, and 7 for FSC satisfies these requirements.

B. In addition to the above two general requirements (one being a definitional requirement and the other pertaining to eligibility for the administrative allocation rules), to further qualify for the prescribed administrative allocation rules, the FSC must satisfy each of the following three categories of requirements outside the United States. In the event the U.S. related supplier or FSC sells to a related buyer (such as a domestic or foreign subsidiary), the activities described in those categories relate to transactions between the seller and the related buyer. Thus, for example, when applying the requirement in Category 1 that the FSC participate outside the U.S. in the negotiation of sales, it will be sufficient for the FSC to participate in negotiation of sales to the related foreign buyer. Sales activities of the related foreign subsidiary, do not play a role in the determination.

Category 1: The foreign sales corporation must participate outside the United States (itself or on a contract basis with a related or unrelated foreign entity) either in the solicitation, negotiation, or acceptance of sales. Solicitation includes advertising, direct mail, or other communications to related or unrelated customers or potential customers. Negotiation includes any communication relating to terms of sale. Acceptance means formal legal acceptance. (a) there is no percentage test or minimum degree of participation required; (b) the test is not measured on a transaction-by-transaction basis; (c) there is no need to prove solicitation produced any sales;

(d) consulting on any of the terms e.c., price, credit or specifications is a satisfactory role in negotiation; and

(e) the transmittal by wire or other means of terms of contract to FSC for final approval is satisfactory for acceptance of sales.

Examples of acceptable activity:

1. Company X sells 10 million widgets for export. All sales activity involves either telephone or face-to-face contact in the United States. FSC of X writes to some potential export customers from time to time offering to sell widgets. FSC also takes out advertisements from time to time in foreign journals. The FSC has no further contacts with export customers. Either of these activities is sufficient to meet the solicitation requirement.

2. During the taxable year, X exports 1,000 units of Product A and 2,000 units of Product B to various world markets. The FSC of X participates outside the United States in the final stages of negotiation of the sale of 50 units of Product A in a particular market. The FSC meets the Category 1 requirement as to all of X's exports.

3. FSC of X provides final legal approval of sales of the 50 units in example 2. The FSC satisfies the acceptance requirement.

Category 2: The foreign sales corporation must perform (itself or on a contract basis with a related or unrelated entity) outside the United States activities that give rise to 50 percent of the costs attributable to the activities described in items 1–5 below, or do substantially all (85 percent or more) of two of the following activities. Only the activities of the related supplier and the FSC are taken into account for purposes of category 2 unless the FSC contracts with other parties for such activities.

1. Process customer orders and delivery: (a) since United States products by their nature must be manufactured or acquired in the United States and shipped from the United States, processing does not include the physical movement of goods or any activity required by United States law or geographic necessity to be performed in the United States, e.g., physical movement (transport to port of exit), required by law (customs clearance), and geographic necessity (packaging and export documentation); (b) processing includes notification to United States supplier of the order and requirements for delivery of the product (c) processing also includes delivery of the product and any activity without the United States with respect to fulfilling the order; and (d) For example, FSC during a taxable year sells 10X widgets and notifies United States supplier of the orders for the widgets, their specifications, and the delivery requirements. The only U.S. activities are delivery, and packaging custom clearances. The FSC arranges for delivery requirements, if any, outside the United States. The FSC meets the processing requirements.

(2) Bill customers or receive payment: (a) billing customers means the final invoice or statement with respect to the conclusion of a transaction or a periodic final invoice or statement where there are numerous transactions within a period but does not include interim invoices or statements which may arise at the time of sale or under a myriad of circumstances; (b) for example, U.S. exporter makes 12 shipments of goods "free on board" port of shipment against buyer's letter of credit. The exporter delivers the goods on board and presents a commercial invoice, the customary clean document in proof of delivery of the goods alongside the vessel, and export license (if required), and any applicable certificates (such as, a U.S. Department of Agriculture certificate of quality) or other government authorization. Having complied with the terms of the letter of credit by presenting these documents, the exporter draws against the letter of credit. The FSC sends a separate final statement (bill) for all 12 transactions during the period showing payment in full, partial payment, or payment due, as the case may be. The FSC meets this requirement; (c) receipts outside the United States for FSC sales must be deposited in the FSC's account outside the United States. Where payment is made inside the United States, the payment may be deposited in the FSC's account inside the United States. The initial receipt in either case may be initially deposited in any account but must be transferred to the FSC's account; (d) with respect to a FSC receiving commissions, such commissions must be paid to its bank account outside the United States

3. Engage in advertising and sales or sales service promotion activities;

a. Only advertising and sales or sales service promotion materials outside the United States are considered for this test.

Examples:

1. Company X engages in advertising in the United States media and supplies promotion materials through trade shows and customer contacts which may result in sales outside the United States. Its FSC is responsible through its activities or by contract with Company X and others for such advertising and promotion activities outside the United States. The advertising and promotion criteria is met.

2. During the taxable year, X exports exclusively to a related distributor in Europe. The FSC periodically places "good will" advertisements in a European publication. In the past, neither the U.S. or foreign affiliates has advertised, and the U.S. exporter nor any of its U.S. exporter's promotional activities have been limited to occasional meetings with officers of the related distributor. Under these circumstances, the FSC meets this requirement.

4. Contract for payment of commissions or fees to related or unrelated sales or sales service agents; and (a) only payment of commissions to sales or sales service agents outside the United States are considered for this requirement, unless FSC makes payments to U.S. agent for sales outside the United States; and (b) for exam-

ple, X Company has a network of agents worldwide. Its FSC contracts for payment of commissions to the agents outside the United States. This requirement is met.

5. Assume credit risk, risk of loss from casualty, damage, etc., and foreign exchange risk:

(a) The FSC may insure itself against such risks to the extent insurance is available or desirable; (b) FSC may assume foreign exchange risk even though all or almost all of its transactions are paid in United States dollars and the FSC may assume a credit risk when a sale of goods is made against buyers letter of credit; and (c) the assumption of economic risk implies a loss or gain for the FSC in addition to that implied by the normal calculation of combined taxable income. If a FSC chooses to incur these additional risks, an additional adjustment will be made to the income allocated to the FSC to determine that portion of the income that will be exempt from tax. The adjustment will be the subtraction from the FSC's income allocation of 17 percent of all losses incurred by the FSC or related parties resulting from the assumption of these risks, and the addition to the FSC's income allocation of 17 percent of all gains of the FSC or related parties from assuming these risks. (An analogous adjustment is made in the case of a FSC utilizing the 1.35 percent rule.) Thus, if combined taxable income of the U.S. exporter and the FSC equals $10,000X, then $1,700X is preliminarily allocable to the FSC under the 17 percent rule. If the FSC incurs losses amounting to $10X due to its having assumed a credit risk, then the $1,700X allocation to the FSC is reduced to $1,698.30X. Conversely, if the FSC were to earn an additional $10X due to foreign exchange hedging transactions, then the $1,700X allocation would be increased to $1,701.70.

For purposes of the 50 percent of costs calculation only cost integrally related to the activity will be taken into account. General supervisory and administrative costs will not be considered for this purpose. The requirement shall be calculated on the basis of FSC's costs associated with all category 2 activities outside the United States over total costs associated with all such activities.

The "substantially all requirement" shall be based on the activity itself and requires that substantially all of the activity be conducted outside the United States. For example, the percentage determinations may be made on a per unit, per order, or gross receipts basis for processing orders, billing customers, receiving payment or assumption of risks. Advertising determinations may be made on the costs of advertising and promotional materials. Payments to agents may be made on a per agent or total commission basis.

In any court proceeding involving failure to meet the administrative income allocation rules, the burden of proof shall be on the Secretary.

Rules for situations where a company creates a FSC and in good faith operates it but fails to meet the administrative allocation rules for a particular year should be provided in order to prevent harsh results. For example, averaging over a period of years, reduction in the 17 or 1.35 percent allocation, correction period, etc. are being considered.

Other activities may be considered to demonstrate economic processes outside the United States. Activities which could be used to satisfy all or a portion of the category 2 requirements are being studied.

Category 3: The foreign sales corporation must perform substantially all (85 percent or more) of the following activities outside the United States: hold board of directors and share holders meetings; maintain a separate bank account and paid-in capital; and disburse dividends, legal fees, board of directors' and officers' salaries, and accounting fees.

Small Business Proposal for DISC Replacement

1. DEFINITION OF SMALL BUSINESS FOREIGN SALES CORPORATION

In order to qualify for the small business exception, the net taxable income of all foreign sales corporations of the related supplier (U.S. parent corporation) must be less than $5 million a year.

2. ARMS-LENGTH PRICING RULES

The administrative allocation rules should be modified for small business to make up for the benefit they lost because they were not subject to the incremental rule under the present DISC rules (otherwise small business would not receive equivalent benefits to those they presently have).

3. REQUIRED ACTIVITIES OF THE FOREIGN SALES CORPORATION

To be eligible for tax exempt treatment under this proposal, the small business foreign sales corporation must: (1) Be incorporated outside the United States and not within a free trade zone of the United States; (2) have at least one resident director outside the United States and not within a free trade zone of the United States; (For purposes of the remaining required activities of the small business foreign sales corporation, the small business FSC may perform any activity required to be performed outside the United States within a free trade zone of the United States.) (3) maintain books and records in that foreign office; and [1] (4) hold an exclusive or non-exclusive agency agreement, franchise agreement, or distribution license with respect to the product.

In addition, to be eligible for the administrative income allocation rules the following functions must be performed by the FSC, or for it on a contract basis, in connection with foreign trading gross receipts; (5) Solicit orders from and negotiate contracts with customers; (6) process customer orders; and (7) bill customers and receive payments.

Furthermore, to be eligible for the administrative income allocation rules the foreign corporation must engage in foreign economic processes by satisfying the following three categories of requirements.

Category 1: The FSC must participate outside the United States in the solicitation, negotiation, or acceptance of sales. Solicitation includes advertisting, direct mail, or other communications to related or unrelated customers or potential customers. Negotiation includes any communication relating to terms of sale. Acceptance means formal legal acceptance.

Category 2: The FSC must perform outside the United States activities that give rise to 50 percent of the costs associated with items 1–5 below, or do substantially all (85 percent) of two of the following: (1) process customer orders; (2) bill customers or receive payments;

(3) engage in advertisting and promotion activities; (4) contract for payment of commissions or fees to related or unrelated agents; and

5. assume credit risk, risk of loss from casualty, damage, etc., and foreign exchange risk.[2]

Category 3: The FSC must perform ⅔ of the following activities outside the United States: (1) hold board of directors and shareholders meetings;

(2) maintain a separate bank account and paid in capital; and

(3) disburse dividends, legal fees, board of directors and officers salaries, and accounting fees.

Where the U.S. exporter or the FSC sells to a related foreign buyer, the activities in categories 1 and 2 above relate to transactions between the seller and the related foreign buyer.

4. TERMINATION OF STATUS AS SMALL BUSINESS FOREIGN SALES CORPORATION

If the average annual net taxable income of all FSCs of a related supplier exceeds $5 million a year over a 3-year period, then the small business FSC will have 3 years within which to meet the requirements prescribed for all other businesses.

Mr. NOWAK. Thank you very much, Mr. Werling, for a very direct and candid assessment of where we are now in our world trade policies. Thanks also for focusing on this small incentive that looks like it really is not doing much for small business now and could in the very near future be doing even less than almost nothing.

You talk about the world trade situation, and how in the last 10 years, especially, manufacturing has left this country for a variety

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[1] For purposes of U.S. tax administration and enforcement, it will be necessary for the books and records to be available for examination in the United States.

[2] The assumption of risk implies an additional burden or gain for the foreign corporation than that implied by the normal calculation of combined taxable income. If a foreign corporation chooses to incur these additional risks, an additional adjustment will be made to the income allocated to the foreign corporation to derive that portion of the income that will be exempt from tax. The adjustment will be the subtraction from the foreign corporation's income allocation of 17 percent of all the losses incurred by the related parties resulting from these risks, and the addition to the foreign corporation's income allocation 17 percent of all the gains for the related parties from incurring foreign exchange risk.

of reasons. I guess one problem has certainly been the unfair trading policies of our so-called trading partners where the subsidy, either direct or indirect, is tremendous.

Looking at our own posture of trying to develop a trade policy with the DISC, and even with that, the little effect it seems to have, if we do not do something very dramatic soon, as you rightly said, you are going to find less and less manufacturing in this country.

We used to think in terms of only the heavy industrial base in this country having to worry about foreign competition. Steel and the auto have not, you know, been competitive, but yet when one realizes that in our new high-tech industry, where a corporation called Atari, having 1,700 people, leaves California and goes to Taiwan, leaving those people behind, you start to wonder where you can even start to make a small difference, because the first very identifiable differential cost of doing business is that labor cost.

The numbers that I received were, I think, very dramatic because the California employee in this new high tech and growing industry was making something like $8.20 an hour. That same production or assembly line worker in Taiwan, where Atari left and now will produce the product, is going to be making $2 an hour.

We are extending this and saying, well, we have to open our doors up somewhere down the line. DISC is that very, very small first part we had, and even that is now going to be termed GATT illegal. Yet the direct subsidies that you had mentioned, and the enticement of your own business to go overseas, and the indirect kinds of barriers that I hear about are just horrendous when you look at what we did to let imports come here from other countries.

I am very concerned about the overall problem, and I can see many business groups and organizations and specific companies, especially, starting to change their whole thought process about this, because it is a problem that an individual company cannot cope with. I can go through a litany of corporations who have either gone out of business or reduced their production substantially because of this import factor.

Mr. WERLING. May I interject something here, because you have hit on a very key point. During the past 2 years, we have lost the opportunity in our company to get over $15 million worth of sales, and that is a lot for small business, and for the first time in our 83-year history, we had a layoff.

We have let more than 100 employees go. We were at 350 employees 2 years ago. If we had had competitive export financing, we would be working overtime in our shop, if not hiring. That is how devastating the lack of a competitive financing position has been on small business. We are not losing sales because of a competitive situation. In fact, the Department of Commerce did a study on our company, under the direction of the Director General. George Washington University did the study on our company, along with several other companies in the United States. Quite to their surprise, their conclusions were really eye-opening findings for them.

No. 1, they found out that the companies they interviewed had very extensive management expertise in the international area. High-quality products, and we were world leaders in their markets.

These were not companies that did not belong in the export market because they had shoddy products and incompetent management. They found out that we were world leaders.

Second, the companies studied are losing the export market because of noncompetitive financing.

Third, that if it is not turned around, many of these very fine small businesses that exist today are not going to be around a few years from now.

Mr. NOWAK. The export financing, the Eximbank, how would you broaden that for more participation? What would your thoughts be on that?

Mr. WERLING. Well, the primary problems that have been facing small business, and now recognizing the fact that on January 18, they made a very substantial improvement by lowering its interest rates, prior to January 18, we were looking at a 250 basis points interest rate differential.

In other words, when we had a prospective sale to a foreign buyer, the cheapest financing we could offer was 250 basis points higher than the OECD arrangement the European competition was offering—they were not violating the OECD agreement, they did not need to. They could finance a sale at 10 percent, and the U.S. Eximbank financed the same sale at 12½ percent. We were not competition for them with that kind of financing.

At least now, we are within one percentage point of being equal to the OECD interest rate.

Now, I want to clarify this because the Eximbank loans the money exactly at the OECD agreement today. The problem is that it has to go through a commercial bank, which tacks on 1 percent. So the financing we can offer to the foreign buyer is still 1 percent above the OECD agreement.

It is not just 1 percent, because it is 1 percent on the outstanding balance this year, 1 percent on the outstanding balance next year, and for the next 5 years under the medium-term program. So it ends up being not a 1-percent differential, but a 2- to 2½-percent differential on the financed amount, which is quite extensive when you are looking at it from the perspective of the foreign buyer.

The second problem facing small manufacturers in this area is that under the small manufacturers' medium-term program, Exim put a cap so they will finance 85 percent of the sale only up to $2½ million. That is an artificial cap; that is not even written into the Eximbank charter. That is an artificial cap that prevents small companies, especially those who are capital-intensive, from making a significant sale.

What happens is that after you exceed the $2½ million sales limit, Exim financers drops to 65 percent financing when the foreign competition continues to offer 85 percent.

As of today, we still do not have an interest rate competitive situation, although it is close, but the most damaging thing today is that after a $2½ million sale, we drop down to 65 percent financing. Our competition consistently, time after time, offers 85 percent, and the big problem we are running into in the international market today is that in any country we go, we have the same competitors.

They will tell the foreign prospect, when the Americans come in with their financing, you will find it is not competitive. In contract negotiations, even before the written proposal goes in, the foreign customer is asking if we can offer competitive financing because they understand from our competition that the U.S. Government will not support competitive financing along the OECD arrangement.

So it is a very serious problem for small business.

Mr. OLIN. Mr. Chairman?

Mr. NOWAK. Yes, Mr. Olin, go right ahead.

Mr. OLIN. Thank you, Mr. Chairman.

I wanted to pursue the subject of Exim a little bit further. Before I do that, I would like to compliment Mr. Werling on a very excellent presentation. I am looking forward to reading the complete text of the presentation, and I think it has been very, very helpful, very constructive.

Mr. WERLING. Thank you very much.

Mr. OLIN. I take it, from your comments just here at the end, that this lack of competitive financing occurred basically during the last years and it occurred at Eximbank. That is the location of the source of the difficulty; is that correct?

Mr. WERLING. Let's put it this way. When we had a change in the Federal Reserve Chairman several years ago, the process of raising U.S. interest rates began.

Mr. OLIN. OK.

Mr. WERLING. Up until approximately 2 years ago, we are able to obtain competitive financing primarily from the commercial banking sector or from Exim. We would prefer to work with the private banking sector if we can. However, these rates became way out of line with international rates, so we had no place to turn but to the Eximbank. I think if you will recall the history of the Eximbank for the last couple of years, it was just, this year, or last year, before we finally had a full complement on the board of directors of the Bank.

We went for an extensive period when the Bank had a moratorium on all financing, and then the financing at Exim was raised to a point that it also was no longer competitive.

Mr. OLIN. I would be interested in your experience with Exim versus mine over the years as being a member of a large corporation in the export market during most of the last 10 years. We found there was normally a tremendous debate at the Eximbank as to whether or not they should literally meet a competitive situation with regard to a foreign government. Their normal practice was to avoid that and I think—did you get the same feeling that I did—that maybe after 1979, when the Fed changed its policy and interest rates went up, that there was also a considerable attempt on the part of the administration to get the Exim to recover its cost of money.

So the Eximbank became very reluctant to depart and meet a legitimate competitive situation with regard to a contract abroad. Yes.

Mr. WERLING. You have hit on a very key point, and I guess as a small businessman, this is probably really one of the sore spots with me because I originally grew up in Indiana on a small farm. I

am a very conservative, Midwestern farm boy by heritage. I will tell you; I do not believe in subsidized financing either. But in the charter—in the Bank's charter—the bank administration has a responsibility that if any subsidized financing exists with our foreign trade competitors, from their governments, the administration has a responsibility to negotiate a reduction or an end to that subsidy.

What has happened recently is that the United States has not been able to totally eliminate foreign financing subsidies; however, the U.S. Eximbank has not been willing to provide financing in line with the OECD trade agreement it helped negotiate.

We do not want subsidized financing. We would much prefer our Government negotiate an end to it. But that will never happen from a practical standpoint. So the choice is either to meet the competition and keep jobs here, or to allow foreign competition, and their governments, to take the jobs away from us.

Mr. OLIN. The way Exim works, as I understand it, is that they try to reach agreement with foreign governments as to an international interest rate.

Mr. WERLING. Right.

Mr. OLIN. That rate normally has been under the commercial rate. The Exim tried to push it up, but they finally reached an agreement.

Then you find out, especially in large transactions, that the foreign governments will cut the rate; they will not abide by the agreement, and then Exim has the question, Do they stay at the agreement or do they come down to a contract-competitive level?

What has been your experience in that regard?

Mr. WERLING. My experience has been twofold here. No. 1, I think that is a very real problem, especially in mixed credits, for larger transactions, but when it comes to small manufacturers, you know, the largest sale, even with durable goods where we put in a complete project, might be $11 or $12 million, and that is large for small business.

Generally, in that type of transaction, up to that level, we will not run into the mixed credit situation. In fact, we have not—in the last 2 years, we have not run into one situation where any of our competitors violated or undercut the OECD agreement. So we have been trying to compete strictly with the international financing agreement that the U.S. Government negotiated.

But the problem that you are talking about is very real, and it exists on dollar amounts probably more from the $50 million transactions on up. It is a very real problem for big business and even medium-sized companies.

Mr. OLIN. All right. I suspect that I am right in line with you on feeling that we need to have orderly credit agreements with other nations, just as we need to have orderly trade agreements. We ought to be doing everything to encourage the administration and our government, regardless of what happens to be, to really be strong in that area.

On the other hand, we do not want to be used by the rest of the world, where they choose to violate agreements or refuse to agree in the first place. To some extent, we have been the good guys and they have been the bad guys, and we have suffered.

I think that we have had some difficulty on a philosophical basis in the administration with regard to how we ought to deal with that. I think that the chamber has a good opportunity to try to work with the administration and get some kind of a reasonable way of dealing with the changing world situation in this regard.

Rather than getting into a fully noncompetitive mode, because of the philosophical question, we need to have a much more pragmatic and realistic mode, and I think if we do that, then we are much more likely to be able to get decent agreements.

If foreign governments find out that they cannot get anything out of cutting the price, essentially, on interest, then they are much more likely to agree to something reasonable and function in an orderly manner.

Does the chamber, as you see it, have this general view? Is the chamber working with the administration with regard to this philosophical subject?

Mr. WERLING. I think in the last 9 months at the chamber, we have seen a very significant change as far as emphasis on small business. The chamber is very supportive of a fully competitive Eximbank for all programs, including those for small business.

This is, I think, somewhat of a shift from 2 years ago. But one of the real problems that we have at the chamber is that there are so few small businessmen and women in the world who have technical experience and knowledge—working knowledge—in the international area.

Then, to try and get them to Washington working on the committees that are necessary, to spend their time, and also money, because it is expensive, it is very expensive to do it, we are starting to move in that direction.

I think we are going to be successful. We have made a lot of progress during the last 9 months, and I think we will see more progress in the future, but we are definitely working in the exact direction that you recommended.

Mr. OLIN. I, for one, certainly feel that your comments about the potential for small business in the world is great. I think the potential of American manufacturers to be competitive throughout the world is high; we are extremely innovative. When we work at it, we can get cost-competitive and there is no reason not to develop a relationship with Government where, in the areas where it is appropriate, the Government can render the help necessary to keep small business competitive with what foreign governments are doing.

We ought to try to match that, try to get it as good as we can, but do not let that stand in our way. I would certainly applaud any efforts that the chamber of commerce can make—particularly with regard to Eximbank developing rules and flexibilities such that it then has the ability to meet situations that small businesses meet.

I assure you, when you get into the multimillion-dollar jobs with big business, they normally will finally meet the situation. With the small business, $1 million or less, I think they normally will not meet the situation.

Mr. WERLING. Incidentally, one other very significant thing that could be done at the Eximbank —and I have made this recommendation to them—one of the problems they have is that they have a

limited staff and so, consequently, the small transactions that small business produces are very cumbersome for them. But they have a perfect vehicle through all the regional banks throughout the country—in Ohio, we have a lot of regional banks that have international departments. The Eximbank knows the banks that are really judicious when it comes to making loans.

I will tell you that the Midwestern banks are very conservative. They have no intention of making a bad loan, whether it be with Eximbank money or their money, because it is a reflection on their operations.

If the Eximbank would merely expand the discretionary lending authority that regional banks have so that they can handle, on an individual basis, maybe a transaction of up to $3 million, the banks are not going to unwisely spend that money.

If we did that, that would probably reduce the workload of small business on the Eximbank by probably 90 percent or more.

Mr. OLIN. Mr. Chairman, I appreciate the time to pursue this line of questioning. This is a little off the DISC subject, but it is probably in total more important to the health of small business than the DISC in that sense.

Thank you very much, Mr. Werling.

Mr. WERLING. Thank you.

Mr. NOWAK. Thank you.

Mr. Britt, do you have something?

Mr. BRITT. Thank you, Mr. Chairman.

It is an interesting comment, you know, in the subsidization of interest and that sort of thing. In a way, in the DISC discussion, when you defer taxes, that is one form of subsidy. Subsidizing interest rates is another form.

But I think when you put it in the context of jobs lost, in other words, the people that did not go to work because you lost those contracts because you could not obtain competitive financing, the Government has actually lost revenues, I expect.

When we take the income that those people would have paid in income taxes; when you look at the unemployment that the Government pays out on the other side of that, it seems to me that if we lived in a perfect world, we might not have subsidization of rates if we could get other countries to observe those kinds of situations, but unfortunately we do not.

You have mentioned, what I think is a very thoughtful and creative idea of expanding the discretionary lending powers of regional banks. Are there other specific provisions that you might have to provide competitive export financing?

Mr. WERLING. I think the most important part is to raise the discretionary caps that they have in the medium programs for supporting small manufacturing exports. Right now, as I said before, once we reach the $2½ million limit, they will not support 85 percent financing anymore.

Then, once we reach the $5 million limit, they will not support 65 percent financing anymore. I mean, my gosh, a $7 million equipment sale is going to provide more jobs than a $2 million sale, and so what they need in the medium-term program is 85-percent financing, the same as our foreign competition offers, and take the cap off of it. Or put a cap at $10 million, or some figure that can

reasonably handle the durable goods industry. It is the capital goods industry that is really losing out in this situation.

You know, we can survive with a 1 percent interest rate differential. Even though that really adds about 2½ percentage points more cost to the buyer. At worst, we can handle that, but it is going to cost us money because we have a very strong dollar today that is hurting our pricing right now.

But the worst thing that we have to compete with right now is going down to 65-percent financing or no financing over $5 million unless you go into the direct credit program, which has primarily been used by big business in the past. But if they would make it 85-percent financing up to maybe $10 million, they would be able to cover probably 99 percent of all small manufacturers, all small companies' export sales on a reasonably competitive basis.

Mr. BRITT. You mentioned the double whammy of the lack of competitive financing, coupled with the transferral to the holding company of the deferred revenues from the DISC. Are there better ways that we could direct the deferred incomes from DISC, without having the small businessman live in fear and trembling until the end of the year to see if he is qualified, without placing burden when losses occur of needing those moneys at the worst possible time, having to pay tax on the transfer?

Is there some other way, a better vehicle, that the same purpose could be held of saying, we are going to defer tax on this DISC income so long as it is directed to certain channels, primarily for the enhancement of export, removing the two problems that we just discussed?

Mr. WERLING. Well, I think we have to look at it from a twofold standpoint. No. 1, if we are looking at retaining the existing DISC concept, then I think we need to drop the stipulations on qualified export assets and the producer loan concept. I mean, just flat-out drop them.

On the other hand, if we need to resolve the legal problem from a GATT standpoint, I think the foreign trade zone concept offers a very possible opportunity to resolve the problems I just mentioned about qualified assets and also producers' loans since they will not exist anymore.

So I think the foreign trade zone concept could solve both our legal problems with GATT and the small business problems associated with the present DISC regulations. That is why I am quite encouraged about the possibilities with the foreign trade zone concept, so long as we keep it from a legal standpoint within GATT, and do not make it so substantive that small business cannot handle it.

Mr. BRITT. Ms. Hagan, in her testimony, however, said—and I notice in your proposal, which I did not have time to look at in depth—you still have the foreign services requirement. A lot of things are going to be happening off the shores of the United States, which raise that impediment of the small businessman having to pay some up-front money on a roll of the dice.

Mr. WERLING. Well, I think that can be avoided. Again, we are looking at whether we can meet the legal requirements. Now, let's look at it from a practical side, from the small business, because here is what I would do.

I would go ahead and set up a legal corporation in the Cayman Islands or someplace of that nature, put $100, or whatever the capital is, into the bank accounts so that we have our offshore bankbook, which meets the GATT requirements. We have offshore capitalization. Since the foreign trade zones are considered outside the continental United States as far as the GATT regulations are concerned, that is our offshore operation.

We would sign contracts with foreign agents in the foreign trade zone, or outside the United States, wherever they do business. We would mail our promotional literature, brochures, sales brochures, whatever, from the foreign trade zone; annually we would keep records in a safety deposit box in the foreign trade zone so we could say that we do have financial records and reports there.

There are ways that it can be done. It is not difficult to hold a board of directors' meeting in a foreign trade zone. So there are ways it can be done so we can meet the GATT guidelines, we can also create an environment that is not overburdening for small business to be able to operate within that legal framework.

Mr. BRITT. Mr. Werling, you would make a good tax attorney.

So you are saying that all of these proposals that you have got in there basically, again, are a form of substance by, which gives me some pause about the whole direction of this thing, not that it does not happen, and I guess if the other countries do it, then, you know. But clearly, what you are proposing, and what I hear from other testimony, is that it is a game we are playing and the only thing that the administration is proposing here is that we just conform our rules to play the game the way it is played in Europe and substance is not at stake.

Mr. WERLING. Well, Mexico is another example, right south of our border, you can bring in work from the United States, you can also hire Mexican labor to put things together. No taxes, it is just the same as if it is different world. We do not have to worry about their regulations.

We are merely proposing the same opportunity to keep the jobs here in the United States.

Incidentally, we have also laid out in appendix 2 the degree of involvement in the foreign trade zone that we would propose be considered for small business.

Mr. BRITT. One final question. Do you have any idea of what proportion of U.S. imports—I guess I am trying to get at how widely involved is small business in foreign countries that are exporting their products to us?

Is it a large proportion? Is it heavily small business or a good percentage of imports into the United States, are those coming from large companies and foreign companies or small companies?

Mr. WERLING. I think to a great degree, they are coming from large companies, but speaking from our own industry's experience, we are finding that some of our competitors in the United States have joined into associations with our European competition to bring in their equipment, rather than make it here in the United States, because they can get more favorable advantages, including export financing from the foreign countries.

So, we are saying that big business has known how to play the game for years, to maximize profits. Now, foreign governments are

contacting small companies, such as ourselves, saying, hey, we can make you more profitable by moving your operation to Europe. We are seeing this happen.

Small companies joining into a venture to build the products in Europe get export financing supported by the foreign governments for sale in the United States, and they still make their profits. We do not want to do that.

Mr. BRITT. If I may ask one more question. The sense I get is that we do not have any kind of—the chairman spoke to this very well—what we seem to need is some way of comprehensively tying all of this together into a policy and into a throughout plan.

Do you have any thoughts about how that might be done? How that might all be pulled together and woven into one fabric?

Mr. WERLING. Well: let me say this. Of all the parts of the Federal Government that I have worked with, and I have worked with most of them, I would say that the Department that has the greatest amount of capability and comprehensive understanding of small business' problems in the export market is the Department of Commerce.

I do not want to blow any one particular person's horn, but I tell you, Rick has done, in my opinion, an absolutely stellar job in working with small business in this area. Rick has a lot of ideas as to what can be done to help small business in the future and make us competitive for the long term in the international marketplace.

I would say the Department of Commerce is the first place to look. I think they have really got a very good perspective of what needs to be done.

Mr. BRITT. Thank you, Mr. Chairman.

Mr. NOWAK. Again, Mr. Werling, we want to assure you that DISC is a problem. In your testimony, you did refer to the need to find competitive financing, which is another aspect of this matter. I think that is why we have the concern in looking at the DISC as a part of that problem which, if it disappears, will loom even bigger as we try to put together what we hope would be a comprehensive package for small business in this whole export program.

Again, we appreciate your testimony, and we will be looking forward to working out some of these initiatives with you. I just look at this business community and the operation of our manufacturing capacity going at a great 69 percent, and yet we are seeing relatively small reductions in inventories and we have an enormous burden with the unemployment problem.

We may have one last frontier of opportunity here to increase exports. We need to put an awful lot of time and effort into that, since some economists have looked at the economy and said there is a shrinking economic pie out there. If we are operating at 69 percent and we are not developing any tremendous shortages, we may have to look for other areas to employ people and to bring manufacturing up to higher levels before we are going to get new investment.

Many people I know that I have talked to about the Economic Recovery Tax Act passed in 1981, have said, "Sure, we would love to use the act to accelerate depreciation, investment tax credit, but you show us where our markets are coming from. We cannot sell the goods we have in the wholesale string now."

Hopefully, we can work together on this because I envision that export financing is going to be very, very important if we are going to be able to move ahead. I do not want to go through the whole problem with the general economy, but certainly I think this has been a decisive factor.

We have blinders on and we are just not looking at world trade. We have always wanted fair trade and to stay away from protectionism, but to do that, those other markets have to open up a lot quicker, and we have to provide, at least an equal amount of—whether you call it subsidy or incentive—if we are going to be competitive.

With the differentiation in wage rates that are existing in the United States, especially in the Third World countries. Unless you use some other mechanism, I do not know how you are going to get a great amount of product out there, especially from the small business community.

We look forward to working with you on the DISC proposals you made. The trade zones are in existence and I think when you look at the vast array of areas in the United States, that they could be set up. There are already existing personnel there, and cooperative ventures that could circumvent any possible conflict of marketing information by being very careful of who the businessman takes as a client or accepts as an agent.

Perhaps we can make this GATT so-called legal and at the same time improve the total program. I think a lot more is going to be needed as far as this incentive if we are really going to make this go.

Thank you very much again.

Mr. WERLING. Thank you very much.

Mr. NOWAK. Our next witness, and our last witness, is from the National Small Business Association, Shaw Mudge, who is president of a small fragrance company located in Stamford, Conn. About 10 to 20 percent of the Shaw Mudge Group's sales are export related. He is a director of the National Small Business Association, and a founder of the Small Business Council of the Democratic National Committee, the DNC.

It is a pleasure to have you before us, Mr. Mudge.

TESTIMONY OF SHAW MUDGE, PRESIDENT, SHAW MUDGE GROUP, STAMFORD, CONN., ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION, AND THE SMALL BUSINESS COUNCIL, DEMOCRATIC NATIONAL COMMITTEE

Mr. MUDGE. Thank you very much, Chairman Nowak.

Chairman Nowak and members of the House Small Business Subcommittee on Tax, Access to Equity Capital and Business Opportunities, thank you very much for giving us an opportunity to state our thoughts.

I have three basic areas, and I think I will stick to the text if you can bear with me for about 15 minutes, because many of the questions that have been asked today are touched upon in this testimony.

My name is Shaw Mudge, president of a small private fragrance company in Stamford, Conn. Presently about 10 to 20 percent of the Shaw Mudge Group's sales are export related.

I am testifying today as a trustee of NSB, National Small Business Association, and as a founder of the Small Business Council of the Democratic National Committee.

Before I begin my testimony, let me thank you personally for responding to my concerns about the pernicious effect that proposed regulation 385 would have had on family-owned enterprises.

Also, thank you for introducing into the House of Representatives yesterday, the Small Business Capital Formation Tax Act of 1983.

I appreciate your inviting me to testify before this subcommittee today on the subject of financial incentives for small business exporters.

To begin, I want to thank you for considering this topic that is so important to American business, to labor, to foreign policy, and especially to the communication that takes place between business people when we trade internationally.

We come to know each other; we learn what the competition is offering, and we anticipate when they can be expected to bring a new product into America's lucrative marketplace.

America is unique in many ways. We have the only constitutionally mandated free trade market. Ambassador Brock told us on Tuesday:

> I am chairman of the National Advisory Council of the Senate Committee on Small Business. We are 65 percent more productive than Japan. We produce 20 percent of the world's GNP, yet only 13 percent of the world's trade.

I think that answers one of the questions that was asked earlier.

You must close this gap through export incentives to small businesses. America will benefit because through international trade, we learn to deal with each other. We are able to monitor both our customers and our competitors. We know who to trust and we find business people who trust and respect us.

In a sense, we have become industrial hostages to each other. Because we need each other, we keep open the global lines of peace and communication.

As American business people, we have come to find that our products are no longer accepted as the best because they bear the "Made in USA" label. We are learning that it is a privilege to sell our products overseas.

When America offers another country, such as Japan, the privilege of selling their products here in this country, Japan, through reciprocity, should then extend the privilege to us, it seems. Instead, foreign competitors, particularly Japan, are not forcefully entering our shores.

I am, therefore, appreciative that you are examining financial incentives for small business exporters. Specifically, you asked me to testify about DISC's.

I understand that DISC's were designed for American businesses in an effort to offset some of the subsidies that foreign governments thrust on their favorite companies: Reduced or eliminated value-added taxes to exporters, in the case of France; mixing for-

eign aid money with other official export credit assistance; as well as exceptionally low-cost extended term export loans, which bear heavily, particularly on Evan Werling's testimony.

These foreign government subsidies are substantial, assured, up-front incentives for our business competitors. In my opinion, these advantages are lacking in the DISC. It is not an up-front, assured incentive.

I am speaking as one businessman who exports and who uses a DISC because the U.S. Government made it available, but it is not an incentive to me because I do not know until December, at the end of the year, after the fact, how much I make. By then, our sales people are on to other sales, other deals, 12 months' production is behind us, and the year's goods have been shipped.

To be effective, incentives must begin in February to motivate sales people, sharpen the accountant's pencil, heighten productivity and convince me, the president of the company, that I have invested my company's resources into the best ventures for that coming year.

Notwithstanding my opinion of DISC's, and I do know that other small businesses would like the DISC to remain unchanged, I thank you for your efforts to encourage American exporters in overcoming the hazards and difficulties in the world market.

The most disconcerting hazard in foreign trade for me, as well as for many potential exporters, comes from legislation hastily passed between Thanksgiving and Christmas in 1977. I am referring to the Foreign Corrupt Practices Act. FCPA is my only disincentive to trade.

Like other small businesses, many of our customers are multinational corporations. We supply them with the essential ingredient in their personal product formulas. Their finished shampoos, deodorants, soaps, skin lotions and other personal products must be tested three ways: For safety, medically, and toxicologically.

These tests may take as long as 2 years at a cost to them, those multinational firms, of as much as $1.2 to $1.5 million. Even the slightest deviation, or a substitution of just one ingredient, causes my customer's product to be subjected again to the renewed expense of safety testing, toxicology, and medical testing. All this to protect the corporation against a possible recall, either domestically or in the smaller nettlesome overseas markets.

Recall could be followed by million dollar lawsuits, loss of reputation, and the inevitable loss of market position.

To prevent such catastrophe, meganational corporations select single-source ingredient suppliers who have worldwide manufacturing capabilities, whether it is in Indonesia, Nigeria, Tanzania, Japan, the Moslem world, Mexico, or Brazil.

Let me assure you that our foreign competitors can meet the standards of international corporations and the largest suppliers have offices throughout the world.

In addition, German and Italian governments are realistic about international trade. For years, the Germans have permitted payment to foreign officials as a deductible item on their books. About 3 years ago, the Italian Parliament wanted absolutely no misunderstanding about this, and they are quoted as saying, "We consider it

good business practice." They have made it a deductible item on their books.

Over 80 percent of my business is with multinational corporations. Two of my customers, for whom we are the most important single-source ingredient supplier, expect me to manufacture in Brazil and Mexico. But no business can operate in Mexico today unless it is 51 percent Mexican owned. Foreigners can only be minority partners having no control, and therefore, no local influence. Yet, ironically the FCPA holds me liable for their actions, which occur without my knowledge or approval.

Without local influence in the company, I am not able to obtain regular and necessary manufacturer's import licenses from the government. These licenses are needed to import the several hundred separate ingredients in my formulas not available in the country where our blending compounding is produced under license.

In Mexico, we fulfill our obligation to manufacture consistently uniform products for our multinational customers through our local licensee. She maintains my high standards of quality control and the confidentiality that we provide from Stamford to the U.S. factories of these same multinationals, two of which are in Buffalo.

But in Mexico, we have a new headache every day. Deliveries are held up sometimes for as long as 3 months and licenses, the endless constant demand for import licenses for the tiniest amount of any of our 3,000 aromatic or chemical/essential oils that are crucial to our fragrance formulas.

Now, because of the distressed financial condition, Mexico is further limiting imports. Fragrance imports have a very low priority, including those for personal products.

Doing business in Mexico is very difficult, even when they are solvent. To quote the February 29 issue of Business Week, which features a story on Mexico's Pemex, "Local union bosses regularly charge fees to jobseekers and union officials are able to collect kickbacks from contractors."

Are payments to union officials exempt from the FCPA? And what of the continuing threat of blackmail against me? For example, suppose someone I do not know in the office of our licensee wants money to leave the country. He or she decides to press false charges against me as an employee in that office.

For honest business people, fear of violating the vague language of the FCPA is the leading disincentive to foreign trade.

Gentlemen, some of you, or more likely your aides, know me as an activist small businessman. I have been fortunate that through hard work by me and my people, we have made money in our independent small fragrance company.

I want to assure you, however, that to date, we have made no money in our export activities. Exporting is high risks for low returns, but exporting offers the opportunity to monitor customers and competitors. Yet I believe that developing world markets is essential for American business and for American society. I hope that in a few years, my exporting investment will become profitable financially, but it is central as a monitoring enterprise activity.

As President of my company, I have made a long-term commitment to exporting. It seems to me that this is the only way small

business can expect to seriously enter foreign markets, not for quick turn-around profit, but for the long-term commitment to monitoring global markets against the day when a profit might be made.

Exporting is hazardous and difficult. Please remove the FCPA disincentive.

As a small business person who is a trustee of NSB and a director of the DNC Small Business Council, I ask the members of this subcommittee to consider passage of Senate bill 414, which clarifies the FCPA, and in doing so, will improve significantly our export trade.

Foreign trade is a national benefit. It expands global markets, and I am certain that we all agree that as leader of the free world, America needs an industrial strategy which was touched upon earlier.

I want to propose today an export segment to our industrial strategy. The development of markets is as important to American business as the building of plants or the purchasing of new equipment. Developing overseas trade markets is an investment in your future.

Therefore, it is essential to encourage small businesses to enter the world marketplace and for them to start selling their products overseas. The Export-Import Bank should do this by actively promoting their loan programs through three avenues: One, establish a mandated small business desk in Eximbank's Washington office. This desk would be equipped with a computer relaying to a satellite, based on the Mitsubishi and the Sogoshosha's model. Together, they would have the capability of immediately communicating with regional loan offices, alerting them to Exim's supply and availability of loan money. This idea is based on the Sogoshosha.

To further benefit exporters, the satellite computer would maintain contact with America's overseas government and commercial departments. The Eximbank loan officers could quickly respond to small business loan requests for potential foreign customers, based on current information related by U.S. overseas offices.

Creditworthiness of foreign companies and other countries where they are located, along with loan availability, would establish the basis for prompt decisions by Eximbank loan officers to their American exporters.

Two, Eximbank must carefully select, train, and cultivate competent, professional loan officers to operate from a desk within each of the 10 regional SBA or Commerce's ITA, International Trade Administration, offices.

The job description of each loan officer will be to vigorously issue Eximbank loans to small businesses.

I am disappointed to learn that William Draper, President and Chairman of Eximbank, said last Thursday, I believe, in front of Senator Boschwitz' subcommittee hearing, that his bank used only some $15 million from the $100 million so-called setaside for small business. What kind of business people do we have at Eximbank who cannot find customers, when over 200,000 small businesses have products that could be exported?

Perception of direction runs our country. The perception of Eximbank is big business. Eximbank should alter that perception by

empowering competent loan officers to aggressively market their loan programs to companies dispersed throughout the country. Not all small business people can fly to Washington by private jet every time a possible exporting opportunity might arise.

Considering that those of us in this committee hearing are not voting residents of Washington, we know our manufacturing firms are thriving in the 50 States, despite their distance from the Capitol, the seat of the Eximbank. The proposed 10 Eximbank regional loan officers must have the drive and knowledge to help your small business constituents in your home districts, to prepare the necessary loan information for them that day.

Moreover, the Eximbank regional loan officers must have the power to give approval within 24 hours. This is not wild-eyed—it is merely competitive.

The key to the Sogoshosha success is that a guy has a deal at 9:30 in the morning, he knows he has the money at 4 o'clock that afternoon. That is the deal. That is what we consider, the availability, the No. 1 issue, prompt availability.

As bankers, loan officers' only effectiveness lies in their mandated power to make loans based on quick decisions, utilizing available funds and at competitive rates. A small business borrower is only as strong as the lending power of his assigned loan officer. This is the lesson of the Sogoshosha: The deal is consummated and fiscally guaranteed in 1 day. I refer you to this book "Sogoshosha," by Dr. Yoshi Tsurumi of Baruch College.

Equally important is the third way that Eximbank will offer incentives and encourage small businesses to export, through exporting, increase U.S. jobs, balance U.S. trade deficit, and monitor the world's market intelligence. Eximbank must mandate that 10 percent of their direct loan budget will be allocated for short term competitive loans, medium term competitive loans, and long term competitive loans to certain qualified small businesses: Those small businesses with little or no export experience.

This means that $380 million will be allocated to the 10 regional loan officers who will vigorously market the loans to competitive small businesses who are not actively exporting.

For the purpose of this Export-Import strategy, I suggest a small business be defined as one with less than 250 employees. The Eximbank loan should be for no more than $1 million for each shipping export declaration.

At the end of the fiscal year, Eximbank's small business loans would be monitored by the Chief Counsel for Advocacy of the SBA. He will deliver annual reports to the President and to the Small Business Committees of both the Senate and the House in a similar procedure used to enforce the much-appreciated Regulatory Flexibility Act.

Further, it is vital that Eximbank again go off-budget. The money spent developing overseas trade markets is an investment in America's future; it is not spending. Eximbank loans are valuable and profitable assets, they cannot be traded as a budget-balancing ploy.

The successful Japanese Sogoshoshas in 1978 operated on a debt-to-equity rate of 8.7 to 1, up to 11.8 to 1. That is where the great work you did for us on section 385 comes in.

It shows in here that in 1978, Mitsubishi's debt equity was 8.7 to 1; C. Itoh was 15.3 to 1, and the Treasury section 385 was going to nail us on a 3 to 1. That is a tremendous asset they have there.

With today's world economic situation, Americans can no longer act on the premise that U.S. companies are competing with foreign companies for the export market. The updated reality is that our meganational American-based corporations now compete with foreign governments.

Ferdinand Marcos flies 16 707's under the name, "Air Philippines," which go all over. At what cost is that to Pan Am and its small business suppliers?

The third segment of America's export industrial strategy for the 1980s', 1990's and beyond is the development of a professional cadre of expertly trained officials, people who have position, knowledge, power, and respect in Government and who can look forward to remaining and growing in the newly proposed Office of Trade.

Members of this corps of competent civil servants will conduct our recommended Export-Import Bank Small Business desk in Washington, as well as in the regional offices, regardless of the 4-year revolving door that has developed for White House occupants.

Other Departments, including Agriculture, Defense, and the State Department, have competent professionals who maintain continuity in their programs. They serve with prestige and with a tradition of selecting and training an effective professional staff.

Together, these long-term professional staffs will help to direct and implement America's industrial strategy into the next decades.

Again, thank you very much for inviting us to testify. NSB joins me in requesting that this subcommittee consider our suggested incentives to encourage more small businesses to export.

In summary, I have condensed the suggestions to three: First, the Eximbank's Small Business desk in Washington, with its computer satellite capability. This advanced technology will bring the Small Business desk in Washington, with its information on loan availability, into communication with overseas commerical departments who have credit backgrounds on prospective small business customers. Both pieces of information will be quickly relayed to the regional loan officers, who will respond to the small business exporter within 24 hours of the request.

Second, through a 10-percent allocation of Eximbank's direct loans for short-, medium-, and long-term lending for the use of qualified competitive small businesses.

Third, by initiating an American industrial strategy for the next decades utilizing a professional corps of expertly trained, competent officials.

Thank you very much.

Mr. NOWAK. Thank you very much, Mr. Mudge. I think your testimony has really been excellent in providing this committee and other committees and Members throughout the House with the record of why not only DISC, but the comprehensive approach that you have taken here, is getting to be necessary today.

The problems of our own economy have only been exacerbated, by the lack of attention given to the area of foreign exports, especially in the small business area. This committee and others in the House will have to seriously consider the very practical suggestions

you make as we try to solve the kinds of problems that are facing our economy.

The Treasury, as you know, in the debt-equity situation, promised to release regs months and months ago and are still saying they are coming out any day now. This DISC problem could be similar.

We certainly appreciate, your testimony here regarding the fact that it really is not an upfront incentive. You have got to wait until the end to see if the benefit is actually forthcoming. So you do not know during the year whether or not it is useful to go through all of the procedure and all of the complexity that is existing now.

Over all of that, of course, is still the problem of trying to be competitive with a tremendous difference in wage and living conditions throughout the world. The world has grown smaller, and your suggestion of using a computer-based system to reach out was not even available 5 or 10 years ago. Today, because of the tremendous advancements in that technology, it is certainly something we should take immediate advantage of.

I appreciate all of that. We are going to try to bring all of this together, and as you see, the testimony, as in many hearings, has gone over into other areas. We have talked a little bit about the lack of market demand out there and the only way we are going to be able to expand is if that market demand expands along with us.

If we cannot reach it, we are going to be in a worse situation than we ever could imagine because we cannot do it only internally; we are going to have to go out and take advantage of every opportunity we can.

The programs that you have mentioned here really can be termed, I think, an investment in not only the American economy, but the world economy. I think there is something that we can now focus on and hopefully come up with a viable part of a comprehensive strategy for this total area.

Treasury, unfortunately, declined to testify today and I think it was mainly because of many of these ideas floating around. We are going to try to pull all of it together for a comprehensive look and I am hopeful that Treasury will be able to take this input and can see the real problem that is out there.

The indirect barriers, I think, from testimony that I received, still may not be overcome, even if we included all the incentives in our law that were mentioned here today. At least, on the financing aspects, we could meet those kinds of terms.

I really do appreciate you taking the time to come and present a very good and comprehensive statement that complements all of the other testimony given today.

Mr. MUDGE. Thank you very much.

Mr. NOWAK. Mr. Britt, do you have any questions you would like to ask?

Mr. BRITT. No questions, Mr. Chairman, just to say that I think it was very perceptive testimony with some very creative ideas. Incidentally, I believe the Department of Commerce has a satellite network for some of its export offices across the country. I believe they have one in my district, which might be something to be looked at.

Mr. MUDGE. Yes. Excellent.

Mr. BRITT. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you again, Mr. Mudge. We will be holding the record open to build a broad base for Treasury's consideration and everybody else.

Once again, I want to thank you for making a superb effort. Thank you very much.

Mr. MUDGE. Thank you very much, Mr. Chairman, I appreciate it very, very much.

Mr. NOWAK. The hearing will now be adjourned.

[Whereupon, at 12:10 p.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

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